The Real Estate M&A and Private Equity Review

Editors
Adam Emmerich and Robin Panovka

Law Business Research

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EDITORS' PREFACE

Publicly traded real estate companies and real estate investment trusts (REITs), with help from real estate private equity, have transformed the global real estate markets over the past 20 years. Their principal innovation, and secret sauce, is '*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.

Publicly traded real estate vehicles have an aggregate market capitalisation of over $1.6 trillion globally, including about $1 trillion in the United States and $200 to 300 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.

Yet, despite the massive growth, the 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 $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 more than 40 countries already boasting REIT regimes.

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

This volume is a multinational guide for understanding and navigating the increasingly complex and dynamic world of liquid real estate and the transactions that produce it. The sea change in the markets 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 instigated by private equity firms or similar catalysts, 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 volume, we have invited leading practitioners from around the globe to offer practical insights into what is going on around the conference table 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 the transactions that produce it, 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 the 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
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Chapter 1

ARGENTINA

Santiago Carregal and Diego A Chighizola[1]

I OVERVIEW OF THE MARKET

During the second half of the 1990s several new types of project were introduced to the Argentine real estate market. City and suburban areas grew at a great pace and new areas in Buenos Aires were developed and consolidated districts strengthened as well. The construction of new roads and motorways encouraged the development of suburban areas where new infrastructure such as hospitals, schools, universities and hotels was also being established. The most successful product types during the 1990s were 'garden towers', which generally offered private security, gym, swimming pools and tennis courts, among other amenities, together with gated communities. Another popular concept of the same period was the introduction of 'lofts'. Lofts projects were developed all over Buenos Aires, Puerto Madero being the most exclusive location for such projects.

Within the real estate market, there has been strong growth in the hypermarket and shopping centre sectors, with most of Argentina's shopping centres having been constructed during the past 20 years. At the start of the 1990s, the city of Buenos Aires also suffered from a shortage of world-class hotels, a situation that has considerably improved, and there are now a number of projects for the construction of hotels both in the city of Buenos Aires and in the interior of the country.

However, even with the changes in the economy during the 1990s and the fact that culturally, and in the absence of other savings alternatives, Argentine investors have generally relied on the real estate market as the main alternative for investments, the local market is still underdeveloped in respect of regulated or listed investment vehicles. In addition, throughout the first half of 2002 and during the worst part of the Argentine economic crisis, prices of lots and parcels in suburban Buenos Aires dropped dramatically driven by uncertainty,

1 Santiago Carregal and Diego A Chighizola are partners at Marval, O'Farrell & Mairal.

creating opportunities for long-term investors. The financial, economic and social turmoil in 2000 and the slow recovery initiated years later limited the development of sophisticated tools to channel investments in real estate.

Between 2003 and 2008, the yearly growth of the construction sector was considerable due to several factors such as the consolidation of real estate investments to safeguard private savings, the recovery of lease prices and an increase in property prices – which have surpassed pre-devaluation prices – all of which served as profit indicators.

From 2008 to 2015, the construction sector's growth decelerated as a result of, *inter alia*, the financial crisis that struck the international markets, resulting in the absence of credit for investors; increased foreign exchange restrictions; and continuing depreciation of the US dollar compared with the Argentine peso.

Likewise, the participation of private equity firms is also low in the real estate sector, with just a few cases of pure forms of private equity participating in the real estate business.

The recent elected government has been openly promising the modernisation of the economy and a shift to a more business-friendly model. Needless to say, clear rules will work as a catalyst for the development and importation of more developed and transparent vehicles, and investment options.

II RECENT MARKET ACTIVITY

i M&A transactions

As a consequence of the deteriorating business atmosphere, harsh foreign exchange restrictions limiting the availability of foreign currency, and few distressed opportunities, there have been no significant real estate M&A transactions within the past three years.

In fact, an overview of the real estate market information would show few residential sector transactions in recent years; investment has considerably decreased in recent years as a result of foreign exchange regulations, lack of financing options and high inflation rates. The commercial office sector has suffered for similar reasons, in addition to slow business activity in general. The rural sector has also experienced a decline in investment, following a series of government policies that have restricted meat exports and fixed wheat and soy prices, in addition to the enactment of a law that restricts ownership and possession of rural land by foreign persons.

Also, the hotel sector that originally benefited from the tourism boom in Argentina ended up suffering an increase in costs as a consequence of inflation and the decrease in competitiveness originally bolstered by foreign exchange rates; the largest hotel developments are in Buenos Aires, which is one of the most visited cities in South America. Finally, there are various opportunities for shopping centre developments in Argentina, in this case not just in Buenos Aires – where the market is quite swamped – but also in other cities of the country.

ii Private equity transactions

There have been no specific real estate private equity transactions within the past three or four years. In Argentina, private equity funds are rare in recent years owing to the unstable macroeconomic and legal conditions for investors.

There have been transactions involving the transfer of participations within private equity funds, but with no real impact on the target assets owned by the private equity firms.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

In Argentina there are no publicly traded REITs. There are, however, some publicly traded companies that act as developers and, on some occasions, operating companies (REOCs) of real estate assets. Although publicly traded, these companies are really privately owned by one or two major shareholders, with a very small portion of the shareholding participations being held by minor investors (float).

The main three public listed companies are:

a TGLT SA: 50 per cent of the shares are owned by a private individual and 50 per cent by private investors.

b Consultatio SA: 70 per cent of the shares are owned by a private individual, 25 per cent by the Argentine government as a consequence of the nationalisation of private pension funds, and only 5 per cent by private investors.

c IRSA SA: 65 per cent of the shares are owned by a private individual; 5 per cent by the Argentine government as a consequence of the nationalisation of private pension funds, and 30 per cent by private investors.

Among the most significant development transactions, Consultatio is developing Catalinas Norte, which at 150 metres would be the tallest building in the City of Buenos Aires, to be used as office space.

Nordelta is a luxury housing development project by Consultatio in Tigre, Province of Buenos Aires. Nordelta is a city centre comprising 23 gated communities, a golf course, shopping centre, private schools, hotels, offices, among other services. Currently, there are more than 30,000 people living in Nordelta. It is estimated that over US$1 billion has been invested in the development, and the project is still being further developed and exploited. A similar project is currently being developed in Escobar, in the Province of Buenos Aires. The development, Puertos del Lago, will consist of 20 gated communities over 1,440 acres of land.

TGLT SA is currently involved in the development of several residential complexes, including Astor Palermo, Astor Nuñez, Forum Puerto Norte, Venice and Forum Alcorta.

One critical challenge faced in large cities in Argentina is compliance with the environmental and zoning regulations, most of which are poorly drafted and inconsistently applied. In addition, the superimposition of provincial and municipal regimes makes the legal framework more complex.

ii Real estate PE firms – footprint and structure

Even though there are not many private equity firms or funds structured and investing in real estate in Argentina, within the existing entities, the following provisions are standard:

a Management fee (or advisory fee) rate: annual fee of 2 per cent of the total capital commitments of all limited partners during the commitment period, and thereafter, 1 per cent of the total funded commitments, declining on an annual basis.

b Carried interest: usually structured as a waterfall that first remunerates limited partners' capital contributions plus hurdle rate (i.e., 8 per cent per annum, compounded annually) and then allocates 20 per cent of the excess to the general partner of the private equity fund.

c Distribution: this is done on a distribution of net proceeds basis, subject only to the customary claw-back.

d Debt: Standard limitations usually cap indebtedness at a range between 15 per cent to 25 per cent of the aggregate capital commitments of all the limited partners. The maximum maturity of any indebtedness for borrowed money of the private equity fund usually does not exceed 24 months. In addition, it is customary for the aggregate borrowings and guarantees against the partnership to be less than or not exceed the aggregate amount of unfunded commitments. In terms of liens, it is common to find provisions stating that the general partner will not be authorised to grant liens on assets of the private equity fund exceeding between 25 per cent and 35 per cent of the aggregate total assets.

e Forced sale provisions: certain members of the PE fund usually can request the sale of a specified real estate property at a specified sale price, providing thereby a first offer pre-emptive right to the other members of the fund. If such parties fail to exercise such right, then the general partner or managing partner may proceed to the sale of the specified real estate property at the requested sale price. Sometimes, the right to request a forced sale is exclusively limited to main initial investors, and is only enforceable after a specified lock-out period of the investment.

Conversely, and as opposed to private equity funds, privately traded trusts are a very widespread tool for pooling funds for developing of residential (mostly) or commercial projects. Investors will receive in exchange an apartment or unit after the project is finished. Many of this type of private trust are focused on constructing residential or office buildings. These trusts usually involve the following participants: (1) the owner or seller of the land, which in turn receives cash or units; (2) the developer, in charge of developing the project, hiring the construction company, and supervising the project; (3) the trustee, which has the obligation to receive the trust property and deliver the units as agreed in the trust agreement;[2] and (4) investors, who make cash contributions in exchange for units.

Private trusts in Argentina have several advantages. Trust property constitutes a separate estate from that of the settlor and the trustee, and thus is ring-fenced against actions of the creditors of both settlor and trustee. This structure provides the possibility of organising projects as entirely separate business units that efficiently isolate the risks of each project, and therefore provide an incentive for investors who believe in the profitability and good planning of the specific venture. By way of contrast, when a real estate project is channelled through one or more corporate entities that, in turn, may develop more than one project at the time, the poor performance of one of the projects may negatively affect the others and creditors of one project may correctly claim from the profits of other projects being developed through the same corporate entity. Additionally, trusts not only provide risk isolation advantages, but also flexibility in relation to the tailor-made structuring of the contributions of each of the trustors (land, cash, rights, construction and development obligations, etc.) as well as of the benefits to be received by each of them (debt interests, profits, apartment or units, etc.) Such flexibility is not available for projects or developments being channelled through a corporate vehicle.

2 The trustee is usually appointed by the developer.

In reality, given the great flexibility and the risk isolation benefits provided by the trust structure, many recent real estate developments are channelled in this way. Argentina went through difficult years with poor macroeconomic conditions, where finance was extremely expensive and sometimes even not available. Trusts are so flexible that they allow different types of investors to co-exist within the same project according to the needs of such enterprise, with each of them being entitled to different benefits according to the risks and contributions made. Corporate structures can hardly provide this flexibility and are also subject to tighter administrative regulations and controls.

Even though trusts are very popular, there are just a few cases of trusts being publicly listed. One such listed trust had Consultatio acting as developer.

Nevertheless, with the new elected government and more professional staff in the securities exchange commission, an increase in the number of this kind of complex project is expected.

III TRANSACTIONS

i Legal frameworks and deal structures

M&A activity in Argentina is mostly driven by macroeconomic conditions. These conditions have affected the investment climate more than anything else in recent years.

Given that all acquisitions are friendly, the structure of a public acquisition will essentially depend on the organisational structure of the target as well as on tax considerations. There have been, as a matter of example, acquisitions comprising the control of a closed company that controls a public company, coupled with acquisitions of direct holdings in such public entity (such structure driven by tax efficiencies derived from a lower capital gains tax applicable to foreign holders of local stocks).

The choice of a structure may also vary depending on the existence of different voting rights of the shares of the target (multiple-vote shares are allowed in this jurisdiction, although they are becoming rarer in public entities) or plans for a post-closing reorganisation, etc.

Specifically in relation to the applicable legal framework, acquisition of real estate M&A and real estate transactions in general are regulated by the recently enacted Civil and Commercial Code (the CCC), which includes the regulation of horizontal property and trusts.

Additionally, according to Law No. 26,737, the Rural Lands Law, foreign ownership of rural land may not exceed 15 per cent of the total amount of 'rural lands' in Argentine territory. This percentage is to be calculated also in relation to the territory of the province or municipality where the relevant lands are located. Ownership by the same foreign owner (i.e., foreign individuals, foreign entities or local entities controlled by a foreign person) may not exceed 1,000 hectares of the 'core area' or the 'equivalent surface' determined according to the location of the lands. The Interministerial Council of Rural Lands, the enforcement agency, defines the 'equivalent surface' taking into consideration: (1) the proportion of the 'rural lands' in relation to the municipality, department and province; and (2) the potential and quality of the rural lands for their use and exploitation. Likewise, under security zone regulations, foreign ownership in certain areas of national security, such as frontier zones, requires the prior consent of a federal agency, which is normally granted. A softening or lifting of these regulations is being studied at the present.

M&A transactions may be structured as transfer of shares or as transfer of assets. The transfer of assets in bulk is regulated by a specific statute, which establishes a specific procedure to follow in order to cut off the liability of the seller with regard to its creditors. Even when this procedure is not mandatory, if not fulfilled, both the seller and the buyer may be liable for the debts related to the transferred assets.

M&A activity is regulated by the CCC and supplementary legislation. Acquisitions are not subject to specific legislation; their regulation stems from the general rules applicable to corporations and partnerships, commercial contracts and securities. Share purchase agreements are subject to the applicable provisions of the CCC, while asset transfer agreements are regulated by Law No. 11,867, the Bulk Transfer Law, which sets forth a procedure mainly aimed at protecting the seller's creditors.

M&A transactions generally fall within the scope of commercial law, with the exception of certain aspects (tax, labour, etc.) that are contemplated in other branches of law. M&A activity involving state-owned companies is further regulated by administrative law.

In general, off-exchange, private merger and acquisition transactions are not legally subject to prior substantive scrutiny by governmental, judicial or other bodies, except where they fall within the scope of antitrust law.

Takeover bids of companies that are authorised to publicly offer their shares are governed by the Securities Law and further specific regulations of the National Securities Commission (CNV). These regulations provide for requirements to be fulfilled in both voluntary and compulsory tender offers. The stock exchanges have not enacted express rules governing takeover bids. However, in the case of listed companies, any disclosure of information regarding any takeover bid that is submitted to the CNV must also be submitted and filed with the stock exchange where the relevant company is listed.

CNV Rules must be complied with by any person who intends to obtain control of a company that makes a public offering of its shares for the purpose of a takeover bid. The Securities Law and CNV Rules apply both to purchase offers and to share exchange offers.

Takeover bids of private companies are not expressly governed by the Law No. 19,550, the Companies Law (the CL) or any specific law. General rules of the CL apply to takeover bids, but such rules do not specifically contemplate tender offers. General rules established in the CCC regarding the execution of contracts may also be applicable (e.g., promise of contract or revocability of the offer).

ii Acquisition agreement terms

The process of acquiring immoveable property can be divided into three main stages: the pre-contractual stage, the contractual stage and the post-contractual or completion phase. The pre-contractual stage normally involves contact with brokers, initial negotiations, preliminary letters of intent and a summary investigation of title and encumbrances. During the contractual stage full and detailed negotiations are normally completed and the contract is entered into between the purchaser and the vendor. The post-contractual or completion phase generally involves the execution of the notarial deed of conveyance, registration of the deed at the Land Registry and any other completion matters (such as notifications to utility services, etc.).

Prior to entering into any form of binding contract, the parties to an acquisition of immoveable property, having agreed upon the main terms and conditions to govern such acquisition, particularly where more complex transactions are concerned, sign a memorandum of understanding or letter of intent setting out the principal terms of the deal agreed between them. The usual terms contained in such a document are those governing price, payment conditions, date of completion, etc., and are established to reflect the agreement between the parties at that stage of the transaction, pending further negotiations and agreement upon the detailed aspects of the operation involved.

iii Hostile transactions

The lack of a developed capital market and the very rare occurrence of hostile takeovers in Argentina has led to local companies not having had the need to include anti-takeover defences in their organisational documents. As mentioned above, the common capital structure of local companies works as the best defence against an undesired acquisition.

The foregoing notwithstanding, when found, defensive measures used in Argentina include: (1) provisions in the articles of incorporation restricting the transfer of shares; (2) increased quorum and supermajority requirements for shareholders' meetings; and (3) staggered-term boards.

'Poison pills'are rare in Argentina, where, in principle, no discriminatory rules may be set out against some shareholders in favour of others. However, some listed companies have included specific change-of-control provisions on their note issuances.

Many of the potential defences are decisions that require shareholder approval in any event, even if they are not implemented for defensive purposes (e.g., all measures that require by-law amendments). Besides, under Argentine law the board of directors is somewhat limited on the type of actions it can take to block a takeover bid, since the performance of the directors is limited to acting in the company's interest.

iv Financing considerations

Trusts

The trust was historically ruled by Law No. 24,441, but recently this structure has been included in the CCC. The characteristics of this innovative financial technique have not been substantially modified. This way of structuring the operation also allows the securitisation of the funds flowing from the project, thus opening up access to the capital markets for financing purposes.

The trust is safe both for institutional and regular investors because of the guarantee that it implies. The assets and funds are secured under a strong institution in order to avoid insolvency issues by isolating them in an independent estate, allowing easy execution. It also provides transparency in the use of the funds, and ensures the future of the resources.

Loans

Lending, including secured lending, was heavily affected by three forces that proved to be disruptive in the local financial market:

a inflation;

b foreign exchange restrictions limiting the ability of local residents and non-Argentine residents to acquire foreign currency (although since December 2015 some *de facto* rules and restrictions have been eased); and

c lack of long-term financing.

Current interest rates in connection with financing in pesos (but also in US dollars) are priced at a rate that, at some points, is even lower than inflation. In other words, inflation has trumped interest rates in terms of percentage and, therefore, interest rates have sometimes even proven to be negative. In light of this issue, the most significant trends have been those aimed at structuring transactions that could mitigate the adverse effects of this situation. Examples of these features are:

a dollar-linked transactions, or financings that are denominated in foreign currency but for which disbursements and repayments are made in local currency. This feature has been used in most recently issued securities (by private entities but also by publicly owned companies) and in some syndicate and bilateral loans. In addition, there are specific regulations issued by the Central Bank of the Republic of Argentina that could be construed as supporting this mechanism; and

b transactions that include terms that allow the lender to request payment of principal and interest in a foreign currency, local currency at a specific exchange rate, or payment in kind.

Finally, since the re-enactment of foreign exchange restrictions in 2001, most financings received by local companies are trade-related financings, the proceeds of which are used by local companies to either finance production of commodities or other exportable goods, or to finance the acquisition of equipment or other goods. This type of transaction is afforded preferential treatment from a foreign-exchange perspective.

At present in Argentina the absence of the financial loans is remarkable. The political and economic conditions of the country in recent years have not been conducive to this special field. The offer of both personal and asset-backed guaranteed loans are lacking in the Argentine financial market. An improvement is expected in this area, because of the new government and the new economic measures announced in recently.

Regarding guarantees, Argentine law recognises two kinds: 'personal' guarantees and 'asset-backed' guarantees. Personal guarantees are granted by a person or a legal entity committing its property to assure the performance of one or more obligations of the debtor. Upon the debtor's default, the creditor may eventually take legal action over the debtor's property and the guarantor's property. This guarantee, unlike asset-backed guarantees, does not create a lien or a privilege in favour of the creditor.

Asset-backed guarantees are granted over a specific property owned by the guarantor. In this kind of guarantee, either the debtor or a third party may be the guarantor. Unlike personal guarantees, asset-backed guarantees grant the creditor (1) the right to pursue the guarantor's property, even if the guarantor sells or transfers the property; and (2) the right to execute the guarantee and receive the corresponding payment with preference over other creditors, even in the event of insolvency or bankruptcy of the debtor or the guarantor.

v Tax considerations

In an M&A transaction, when both, seller and buyer, are non-Argentine residents, the seller may choose between an effective tax rate of 13.5 per cent of the sale price or 15 per cent of the 'real' net income. The buyer is the party liable to pay the tax. However, there is no mechanism created for the buyer to pay the tax due. In practice therefore this type of transaction is not subject to capital gains tax. If the seller is a local entity, the potential gain or loss will be treated as part of its corporate income.

Also, if there is an 'instrument' signed by both parties regarding the purchase and sale of shares, quotas or any other equity participation issued by an Argentine company, that instrument would be subject to stamp tax in the Argentine jurisdiction in which the instrument is entered into or where it has effects (where the Argentine company is incorporated). Both parties are jointly and severally liable for the payment of this tax to the tax authority. If one of the parties pays it entirely, it might have the right to claim half of the amount from the other party. Usually, the tax is borne by the party who is resident in the country, if any. The tax rate in the City of Buenos Aires, for instance, is 1 per cent and it applies to the total economic value of the agreement. A non-Argentine resident has no regulated mechanism to pay this tax. Therefore the tax is not actually collected.

Regarding the formal requirements, the non-resident that wishes to acquire shares, quotas or any other equity participation of an Argentine company must obtain an identification number for tax purposes.

vi Cross-border complications and solutions

There will likely be an evolution in the next few years toward international standards. Lack of clear rules and an overly regulated and unstable economy have played a major role in diminishing, if not eliminating, M&A activity by listed entities in Argentina. The underlying reasons can be found in the external factors rather than the overlooking of specific transaction components.

The real estate sector, which has been a major player in prior comebacks of the Argentine economy, will most likely recover. Prices are still cheap relative to regional and international standards so international developers can be expected to return to the market.

Restrictions on the foreign exchange market are being lifted by the new administration.

V CORPORATE REAL ESTATE

There is a trend to separate real estate from operating activities specifically in the hotel field, where management contracts are usually signed between the owner of the asset and operating companies.

VI OUTLOOK

The Argentine government has recently launched a general tax amnesty. It is expected that in the next few months a significant number of assets owned by Argentine residents will be disclosed and taxed, and in some cases repatriated to Argentina. This regime, coupled with more restrictive regulations in foreign financial markets, is pitched by the government as the final opportunity for declaring assets before broad exchanges of information with other countries are put in place or become effective.

As an alternative to repatriating funds, investments in open or closed mutual funds listed with the Securities and Exchange Commission (SEC) grant a beneficial tax treatment. In turn, one possibility for these mutual funds is investing in infrastructure and real estate projects. These funds will be specifically regulated by the SEC.

This alternative could be attractive to those taxpayers who prefer to disclose their assets and consider investment in the real economy or infrastructure at the same time.

Beside this promising tool, as a consequence of our financial and political instability, the absence of institutional investors and the lack of appetite for stocks as a valid saving option, there are very few listed and sophisticated vehicles to channel investments in real estate and the presence of international private equity is still very low. Indeed, general macroeconomic conditions made the local capital markets largely unattractive for initial public offerings or M&A in general.

On December 2015 a new government took office with a focus on generating a more business-friendly climate. An important first step was settling a major international claim with hold-outs of defaulted Argentine sovereign debt that put an end to a 13-year default. Such default has been a big obstacle to boosting the access of the country and its companies to financing through the capital markets. Additionally, many of the restrictive measures affecting the access of residents and non-residents to the foreign exchange market were removed.

On these grounds, there are high expectations for Argentina's economy to recover, particularly through foreign investments in infrastructure and real estate. Real estate has been important for Argentina's economic recovery in the past, and is expected to also foster the recovery this time.

Chapter 2

AUSTRALIA

Philip Podzebenko and Robert Bileckij[1]

I OVERVIEW OF THE MARKET

The Australian real estate market is highly securitised, with a significant portion of the country's commercial real estate being held through listed and unlisted real estate investment trusts (REITs).

REITs first appeared in Australia in the early 1970s and have steadily grown in number, size and complexity. Today, there are around 50 REITs listed on the Australian Stock Exchange (ASX). Commonly referred to as 'A-REITs' (and previously, 'listed property trusts' or 'LPTs'), listed REITs represent a total market capitalisation of around A$135 billion and are important players in the broader Australian market.[2]

There is also a substantial unlisted property trust sector in Australia, with a number of listed REITs and privately owned operators also managing unlisted funds that often target larger institutional and sovereign wealth investors from Australia and offshore through syndicate, club and joint venture-style structures.

As a result, larger real estate transactions in Australia tend to reflect a 'corporatised' model involving large-scale mergers and acquisitions, takeovers, spinoffs and other securities market transactions (as distinct from the more traditional real estate conveyancing). The

1 Philip Podzebenko and Robert Bileckij are partners at Herbert Smith Freehills. The authors would like to thank Melita Cottrell, who wrote the banking section, and Daniel Sydes of Greenwoods & Herbert Smith Freehills, for the tax section. The authors would also like to thank Timothy Coorey and Bianca Doyle for their assistance with background research. Unless otherwise indicated, data as to ASX capitalisation obtained by compiling data from the ASX website as at June 2016.

2 Australian Stock Exchange, 'ASX Funds (Listed Managed Investments, Funds and ETPs) Monthly Update – May 2016' (Report, May 2016), www.asx.com.au/documents/products/ASX_Funds_Monthly_Update_-_May_16.pdf.

past 12 to 24 months has seen significant activity in the sector including hostile and friendly takeover activity, reconstructions and divestment of large portfolios, reflecting a trend towards increasing consolidation in the industry.

Australian REITs have attracted substantial investment from offshore, including significant inflow from Asia and a number of large sovereign wealth funds, with the lower Australian dollar in recent years (reflecting record low interest rates) and relative economic stability being key contributors to the comparative attractiveness of Australian real estate. In 2015, total foreign investment in the sector was estimated at over A$20 billion, involving more than 400 transactions.[3]

Private equity firms have also been active in the Australian market, with both international and Australia-based real estate private equity firms engaging in significant transactions over the past 24 months.

II RECENT MARKET ACTIVITY

i M&A transactions

The Australian market has seen a number of high-profile REIT M&A transactions in recent years reflecting, in particular, the trend towards consolidation in the sector. Three of the more significant transactions are:

a the separation of the former Westfield Group into two new listed property groups, Scentre Group and Westfield Corporation (currently the two largest listed REITs on the ASX);

b the formation of Vicinity Centres (currently the third-largest listed REIT on the ASX); and

c the proposal by Dexus Property Group to acquire Investa Office Fund (and associated proposals).

Westfield separation

Scentre Group is the largest ASX-listed manager of Australian retail assets, with a portfolio focused on investing and operating retail property in Australia and New Zealand and a market capitalisation of more than A$25 billion. Its management platform is internalised within the REIT structure (that is, the trustee and management platform is wholly owned as part of the listed vehicle) and includes capabilities covering property management, leasing, design, development, construction, marketing and funds management.

Westfield Corporation is an internally managed international retail property group with a focus on the US, UK and Europe. It has a market capitalisation of more than A$22 billion.

Each of these REITs was formed out of the restructuring in 2014 of the former Westfield Group. The transaction involved:

a separating the Australian and New Zealand business from the international business of Westfield Group; and

b merging Westfield Group's Australian and New Zealand business with the separately listed Westfield Retail Trust.

3 Based on S&P Capital IQ data on 'Foreign Investment in Australian Real Estate' for the period from 1 January 2015 to 31 December 2015.

Broadly, the transaction was effected using schemes for the Westfield Group and the Westfield Retail Trust. As those entities comprised both trusts and companies, the schemes involved a combination of trust schemes and company schemes of arrangement. While the processes are technically different in a number of ways (see further Section IV, *infra*), they each involve preparation of a detailed disclosure document and a vote of security holders.

For existing Westfield Group security holders, the transaction consideration involved receiving securities in the new Scentre Group and Westfield Corporation REITs in exchange for their securities in Westfield Group. For the existing Westfield Retail Trust security holders, the transaction consideration involved receiving a combination of securities in the new Scentre Group REIT and a cash component in exchange for their securities in Westfield Retail Trust. In each case, this reflected an agreed merger ratio.

Implementation of the scheme proposals involved a range of legal mechanics that have evolved in the Australian market, including stapling entities so that their respective securities trade together as a single listed security, destapling other entities, delivering securities to investors through capital distributions and delivering cash consideration through returns of capital.

Vicinity Centres

Vicinity Centres is Australia's second-largest listed manager of Australian retail assets, with a market capitalisation of more than A$13 billion. Its management platform is internalised within the listed REIT structure.

Vicinity Centres was formed by the merger in June 2015 of two significant listed REITs, Federation Centres and Novion Property Group.

The merger was effected by Novion schemes of arrangement (requiring approvals of Novion security holders) whereby each security in Novion was exchanged for securities in Federation at an agreed merger ratio (effectively valuing the Novion stock at about A$7.8 billion).

The proposal was supported by the boards of both REITs and, as such, an implementation agreement was put in place incorporating customary deal protections and mutual break fees (see further Section IV, *infra*, on schemes processes and customary implementation terms). Disclosure of key information for Novion security holders in considering how to vote on the schemes was outlined in a detailed scheme booklet, as required by Australian law.

Prior to the merger, Novion (previously known as CFS Retail Property Trust Group) had itself been the subject of significant restructuring through an 'internalisation' proposal. This involved the REIT acquiring its trustee and management platform from its original sponsor (Commonwealth Bank of Australia) together with Commonwealth Bank's property asset management business and commencing the management of a number of wholesale property funds and mandates. The total consideration under these transactions was approximately A$460 million.

As this transaction essentially involved the board of the REIT trustee engaging with its parent group, arrangements were put in place to ensure independent consideration of the transaction from a REIT investor's perspective.

Investa Office Fund

Investa Office Fund (IOF) is a leading owner of investment-grade office buildings, with investments located in core CBD markets throughout Australia and has a market capitalisation of more than A$2.5 billion.

The trustee and management platform of IOF is externally owned, having been established as part of the Morgan Stanley-owned Investa Property Group.

In 2015 Morgan Stanley commenced processes to exit its position in the Investa Property Group, with two key strands being disposal of its substantial portfolio of Australian office towers and disposal of its funds management platform, spanning both the management of IOF and another large unlisted wholesale REIT, Investa Commercial Property Fund (ICPF).

The sale of Investa Property Group's portfolio of office towers was completed in 2015. A Chinese sovereign wealth fund, China Investment Corporation, was the successful acquirer with a bid of more than A$2.45 billion.

Processes for the sale of the funds management platform continued through 2015 and the first half of 2016. A committee of the independent directors of the trustee was formed to consider the implications of that sale process from an IOF investor's perspective.

A proposal for IOF emerged from Dexus Property Group (a large ASX-listed REIT with a market capitalisation of more than A$8.5 billion) to acquire all of the securities in IOF via a trust scheme, with consideration offered comprising a combination of cash and Dexus scrip.

As the IOF independent directors were supportive of the Dexus proposal, an implementation agreement was put in place between the parties reflecting their respective commitment to the proposal, key actions required of each party and closing conditions. As the trust scheme required IOF security holder approval, the proposal was conditional on a vote passing by the required majority (75 per cent of members present and entitled to vote in this case).

Immediately prior to the vote, Cromwell Property Securities Limited, as responsible entity for Cromwell Diversified Property Trust, acquired close to 10 per cent of IOF and ultimately the vote fell short of the requisite majority and the Dexus proposal did not proceed. The Investa funds management platform had been acquired by ICPF prior to the IOF vote, effectively positioning the IOF security holder vote as a decision between acquisition by Dexus with an internalised management structure or continuation with an external management platform now owned by ICPF.

Given the different elements in play, the process attracted significant attention in the Australian financial press. It highlighted in particular the challenges that externally owned trustee boards can face in weighing up competing proposals where one of those proposals may involve the corporate owners of the trustee.

ii Private equity transactions

Real estate private equity firms have been active in acquiring and disposing of a range of real estate assets over the past few years. Particularly more recently, significant recent real estate private equity transactions in Australia have been characterised by a material development component. Recent transactions include:

a Blackstone Real Estate's acquisition of Goldfields House and its repositioning and subsequent sale of the property to the Dalian Wanda Group; and

b acquisition by a consortium led by Mirvac of the Australian Technology Park for redevelopment with an estimated final value of A$1 billion.

Goldfields House

Goldfields House was an office building built in the 1960s, with a prime Circular Quay location directly overlooking Sydney Harbour. It had been acquired for A$245 million by the Valad Property Group, an ASX-listed stapled REIT (together with Valad-advised funds and investors) in 2006. Following the 2007–2008 financial crisis, Valad faced ongoing funding constraints.

In its first foray into the Australian market, Blackstone Real Estate built a blocking stake in Valad by purchasing exchangeable securities that Valad had previously issued to Kimco Realty Corporation. Blackstone subsequently proceeded to acquire the ordinary securities in Valad for A$208 million by way of a scheme of arrangement and trust scheme on terms agreed with Valad. The acquisition was completed in late 2011.

Following its acquisition of the Valad management business and its co-investment interests, Blackstone continued Valad's repositioning of Goldfields House, obtaining planning approvals for two new residential towers and substantial increases in building height. It also raised leasing levels from 68 per cent to 90 per cent and restructured leasing arrangements for the building so that all leases extending past 2017 would have break clauses allowing the landlord to terminate the lease.

At the end of 2014, Blackstone sold Goldfields House to Dalian Wanda Group for A$425 million, capitalising on strong Chinese interest in Australian real estate assets.

Australian Technology Park

The Australian Technology Park is a 14-hectare industrial redevelopment site in inner-city Sydney originally owned by UrbanGrowth NSW, the New South Wales government's development agency. In 2015, UrbanGrowth conducted a tender process for the acquisition and urban renewal of the Australian Technology Park site.

Mirvac, an ASX-listed property developer and fund manager, led a consortium comprising Mirvac, the AMP Wholesale Office Fund and SunSuper, together with co-tenderer Centuria Group. The consortium and co-tenderer won the tender for the site, paying A$263 million and committing to a development programme for the site with an estimated final value of A$1 billion.

In support of their bid, the consortium agreed a 15-year lease to the Commonwealth Bank of Australia of 93,000 square metres of office space to be developed on the site. Mirvac will be responsible for managing the development and construction of the precinct, and for ongoing management of the precinct once construction is completed.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

The larger publicly traded REITs in Australia have significant market capitalisations and are typically structured to hold (in a tax-efficient way) both passive real estate investments and active business operations.

The top 20 listed REITs range from a market capitalisation of just over A$25 billion to a market capitalisation of around A$1 billion. As noted above, the two largest REITs, Scentre Group and Westfield Corporation, were formed following the restructuring in 2014 of the Westfield Group. Their respective market capitalisations are about A$25 billion and A$22 billion, while the next largest REIT, Vicinity Centres, has a market capitalisation of about A$13 billion.

A-REITs have historically been structured as unit trusts, with a key benefit of this being the ability to access flow-through tax treatment where the trust holds passive investments (and does not conduct an active business). This means that income and gains derived through the trust are taxed in the hands of investors at their applicable tax rates.

The increasing sophistication of the market, and diversification of key participants, has driven the development of a range of innovative structures. Most notably, almost all of the larger listed REITs in Australia now use a stapled structure where two or more securities (typically units in a trust and shares in a company) are jointly quoted on the ASX (under a single code) and trade together, with each investor owning a corresponding proportion of each entity.

This can allow for 'flow-through' tax structuring for passive real estate investments held in the trust, coupled with access to the returns of an operating business conducted by the company. Typically, the operating business activities are complementary to the holding of real estate assets, for example, funds management, asset management, leasing and property development.

The stapled structure has also been used as a mechanism for 'internalisation' of the management of listed REITs. Internalisation involves the REIT management being owned and operated within the listed structure (on the operating business side of the stapled entity) as opposed to the REIT being managed by an externally owned entity with fee leakage. Almost all of the larger listed REITs have moved to an internalised structure. Internalisation can also be adopted for unlisted REITs, but is less common.

Larger A-REITs have tended to focus on more traditional real estate classes (retail, office, industrial and residential). Others, such as Lendlease Group, have a multi-disciplinary focus across the full spectrum of the property life cycle and also operate in areas such as infrastructure (which can also be efficiently accommodated through the stapled structure).

More recently there has been increasing interest in alternative real estate classes including healthcare, retirement living, student accommodation, childcare and manufactured housing. This was particularly evident from the REIT IPO activity during 2015, where three of the four REIT IPOs in that period fell outside the more traditional asset classes.[4]

Many of the larger listed REITs have a significant global footprint. For example, Westfield Corporation operates in the US, UK and Europe and Lendlease has operations throughout Australia, Asia, the Americas and Europe.

ii Real estate PE firms – footprint and structure

Real estate private equity firms in Australia comprise a mix of Australian-based specialist managers (including the Goodman Group, Centuria, Altis, Propertylink, Abacus and CorVal) and large international real estate private equity fund managers (including Blackstone Real Estate, Morgan Stanley Real Estate Investments and KKR). Unlike the global private equity houses, Australia's traditional private equity firms have generally not expanded their activities into real estate investment, although they are increasingly looking at alternative asset classes with a significant real estate component.

A number of the larger listed A-REIT managers and developers (such as Lendlease and Mirvac) also manage funds focusing on real estate private equity using their integrated funds management platforms and development capabilities.

4 *Property Investment Research*, 'December 2015 Editorial – 2015 in review' (Monthly Review, December 2015), https://pir.com.au/reviews/82.

Real estate private equity operations in Australia are characterised by the active management of real estate assets, focusing on repositioning, releasing and differing degrees of development of portfolio properties. Over the past five years, private equity real estate investment activity has gradually shifted from higher-risk opportunistic transactions, such as acquisitions of real estate-backed debt portfolios, securities market transactions and acquisitions of highly leveraged distressed assets, to value-added investments and alternative real estate classes. Investment vehicles vary in size ranging from below A$100 million in real estate assets to over A$10 billion.Real estate private equity firms adopt a variety of approaches to structuring investments, depending on the type of asset, the manager's position in the market, and the level of oversight which investors wish to exercise. These range from joint ventures (or clubs or syndicates), to the wholesale fund structures more commonly used for investment in other real estate asset classes.

Australian real estate private equity firms typically use externally managed unit trust structures (whether the investment vehicle is a joint venture or a wholesale fund), although single-asset investments can also be structured as direct co-ownerships of the underlying real estate assets. As for A-REITs, unit trust structures provide flow-through tax treatment where passive investments are held. Management of and development activities, where the purpose is to retain the assets within the investment vehicle (rather than, for example, development for sale), generally do not compromise the flow-through tax treatment of such trusts.

Offshore real estate private equity funds typically invest in Australia real estate assets through unit trusts, leveraged corporate structures, or (where suitable) direct ownership of the underlying assets.

IV TRANSACTIONS

i Legal frameworks and deal structures

REITs are primarily constituted in Australia as unit trusts comprising a separate trustee and the trust estate. General trust law principles apply to the establishment and operation of unit trusts, including detailed rules about matters such as the trustees' powers and fiduciary duties owed to investors.

Overlaying this is an extensive investor-protection regulatory regime under the Corporations Act 2001 (Cth) (the Corporations Act).[5] The majority of this regulation only applies where a REIT is required to be registered as a 'managed investment scheme'. Registration is generally required where REIT interests are issued to retail investors (which will be the case for all listed REITs). A REIT may voluntarily register even in the case where it only has wholesale investors and therefore does not need to register, for example, to signal to investors that the more prescriptive statutory investor protection regime will apply to the management of the fund.

To be registered under the Corporations Act, the trustee of a REIT (known as a 'responsible entity' under the Corporations Act) needs to hold an Australian financial services licence covering the operation of the REIT. This requires the trustee to demonstrate the requisite capability to perform its functions as a responsible entity, as well as meeting minimum net tangible assets requirements. There are various options available to prospective fund sponsors such as engaging professional trustee companies to perform the responsible

5 See Chapters 5C and 7 of the Corporations Act.

entity function, with the fund sponsor providing critical management support. However, this introduces operational complexity and fee leakage and is typically only considered by new entrants into the market as an interim measure while a licence is being obtained.The Corporations Act provides for the trustee of the REIT to be the single entity responsible to investors in relation to the operation of the REIT (in contrast to separate trustee and manager structures used in other jurisdictions). In practice, trustees will delegate management functions either to a manager under common ownership with the trustee or a third-party manager.

Registered REITs are subject to a range of requirements under the Corporations Act including as to fundraising, takeovers, financial reporting and related-party transactions.

REITs that are listed on the ASX are also subject to the ASX's listing rules. These include rules for continuous disclosure of materially price-sensitive information, rules promoting good corporate governance, and rules regulating investor dilution and restricting related-party transactions and significant changes in the nature or scale of activities without appropriate investor approvals.

The statutory regime is primarily overseen by the Australian Securities and Investments Commission (ASIC) as the chief corporate regulator in Australia. The Takeovers Panel which acts as the primary forum for resolving disputes about takeover bids may also be involved in regulating control transactions for listed REITs.

Particular features

Particular features of the Australian legal framework for REITs include the following:

a Governance complexities are often evident where a REIT's management is owned separately from the REIT's securities (as is the case for externally managed REITs). Interests can diverge between the shareholders in the trustee and manager and REIT's investors (for example, where a transaction may result in the corporate trustee losing management control of the REIT and associated fee streams). This can place directors, and executives, in a position of conflicting responsibilities and interests. Practically, this is typically managed through detailed governance protocols, including establishing a committee of independent trustee directors to manage transactions from an investor perspective (with conflicted executive directors abstaining).

b Restrictions apply to security holders voting on resolutions of REITs that are registered as managed investment schemes.[6] In particular, the responsible entity and its associates may not vote their securities if they have an interest in the resolution other than as a member of the REIT. This can require detailed analysis (and sometimes Takeovers Panel and court action) to determine who is entitled to vote on REIT matters such as approval of trust schemes (as further described below).

ii Acquisition agreement terms

Deal structures and terms vary depending on a range of factors, including whether the REIT is listed or unlisted, concentration of investor holdings, and whether the objective is to take ownership of the REIT and its underlying assets or to assume control of the management of the REIT. Tax and stamp duty considerations are also relevant.

6 Section 253E of the Corporations Act.

Broadly, the Corporations Act prohibits a person from acquiring more than 20 per cent of a listed REIT (or increasing an interest above 20 per cent) unless a permitted gateway applies.[7] The most common techniques to acquire control of listed REITs within this framework are an off-market takeover bid regulated by the Corporations Act or a trust scheme.

Takeovers regulation under the Corporations Act does not apply to unlisted REITs. Accordingly, a buyer might engage directly with individual investors to acquire their interests on whatever terms the buyer wishes (subject to any transfer restrictions in the REIT constitution or relevant unit holder agreements). Alternatively, a trust scheme may also be used (which may be more efficient where an unlisted scheme has a number of members).

Where the primary objective is to gain control of the REIT's management, rather than ownership and control of the REIT (and its underlying assets), a further alternative is to seek to replace the trustee of the REIT, which can be effected by a REIT investor vote where REITs are registered as managed investment schemes (or where the REIT's constitution specifically provides for REIT investors to replace the trustee).

Takeovers and trust schemes

Under an off-market takeover bid, a bidder makes separate but identical offers to all holders of securities in the target to acquire their securities. The process is highly regulated and involves the following elements:

a the bidder prepares a bidder's statement (containing details of the offer and bidder, its funding intentions and other material information known to the bidder), which must be lodged with ASIC and the ASX;

b the target prepares a target's statement (containing the recommendations of the directors of the trustee of the target and other material information known to the target), which must also be lodged with ASIC and the ASX;

c regulator consent is generally required to withdraw an offer, and there are various limitations on offer terms (for example, the offer must be open for a minimum period, maximum acceptance conditions cannot be imposed, conditions within the bidder's control cannot be imposed and consideration cannot generally be reduced); and

d compulsory acquisition of non-accepted securities is permitted following a bid if the bidder and its associates gain at least 90 per cent of the bid class securities during the bid period (and have acquired at least 75 per cent of the securities bid for).[8]

Under a trust scheme, the target trust's unit holders vote to amend its constitution to enable all of the units in the target trust to be transferred to the bidder. A trust scheme may also be used to implement the stapling of the securities of two entities to trade together (rather than one entity acquiring another). In these circumstances a vote of the security holders of both entities is often required.

Market practice has developed such that the process for implementing trust schemes parallels the scheme of arrangement process under the Corporations Act, which is used for consensual company acquisitions. The trust scheme process involves the following elements:

a a disclosure document is provided to the unit holders who are required to vote on the proposal (including details of the offer and acquirer, information about its

7 Section 606 of the Corporations Act.

8 See Chapters 6 and 6A of the Corporations Act.

funding and intentions, a recommendation of the target trustee's directors, usually an independent expert's report, and any other material information known to the target and the acquirer);

b court approval of a trust scheme is not mandatory (unlike company schemes of arrangement), although 'court directions' to the trustee are sometimes sought to the effect that the responsible entity would be justified in effecting a trust scheme based on an affirmative vote; and

c a trust scheme is binding on all unit holders if approved by the requisite majorities (being 75 per cent by value of votes cast to approve an amendment of the trust's constitution and a majority of votes by value cast to approve the acquisition of control).

In a stapled trust and company structure, the transaction would require inter-conditional trust schemes and company schemes for each entity making up the stapled entity.

For both schemes and takeovers the consideration may comprise cash or scrip or a combination of the two. As further explored in Section VI.v, *infra*, tax considerations, including availability of roll-over relief from capital gains tax, will often be a key factor in determining the consideration offered.

Implementation agreements between the target and bidder are common for trust schemes and friendly takeover bids. They will contain typical deal protection mechanisms, including:

a exclusivity arrangements such as no-shop and no-talk provisions (subject, in the case of no-talk provisions, to fiduciary outs, allowing trustee directors to talk to rival bidders if it is in the best interests of the target's investors), notification and matching rights in favour of the bidder if the target receives a competing offer; and

b break fees for the bidder of up to 1 per cent of the bid value (with reverse break fees in favour of the target being more unusual in Australia).[9]

Whether a target provides due diligence access will generally depend on the acquirer's indicative bid price.

Bidders can acquire a pre-bid stake of up to 20 per cent. Pre-bid stakes are not used as frequently for trust schemes as the bidder cannot vote their securities in a trust scheme. However, it is generally possible to provide for option or voting agreements up to 20 per cent if structured appropriately. Stakes above 5 per cent must be disclosed to the market, and statutory beneficial ownership tracing rules can reveal smaller stakes. Derivatives such as cash-settled equity swaps are also commonly used to acquire stakes of up to 5 per cent without requiring disclosure to the market or the target.

Private sale

Private sale processes for REITs tend to follow a substantially similar process as for the sale of a company or business.

A formalised sale process may be run with specified timelines for expressions of interest, selection of preferred bidders, due diligence and binding bids. This is generally

9 The 1 per cent break fee reflects Takeovers Panel guidelines as to the level of break fee that is not likely to be regarded as an unreasonable lock-up device; see Takeovers Panel Guidance Note 7: Lock-up devices.

the case for transactions involving the sale of a large asset portfolio, with investment banks typically engaged to coordinate the sales process. For smaller portfolios, sellers often conduct their own sale processes (or the trustee may be empowered do so under the relevant trust constitution) with known contacts who may be potential buyers.

The primary sale document is typically a form of unit sale agreement. Key terms typically include conditions precedent (with any required foreign investment approvals for offshore buyers, waivers of pre-emptive rights affecting material assets and confirmation of no material adverse effect being the most common), payment of a deposit (5 to 10 per cent of purchase price is common, although sometimes no deposit is payable), warranties (covering usual matters such as title and capacity, ownership of underlying assets and claims affecting the REIT and assets), restrictions on the operation of the REIT between signing and completion outside the ordinary course (by reference to the ability of unit holders to control the trustee's actions), and steps to enable the change of trustee following completion.

Change of responsible entity

Under the Corporations Act, the responsible entity of a REIT can be replaced by a resolution of unit holders, being an ordinary resolution of unit holders present and voting for a listed REIT and an extraordinary resolution of all unit holders entitled to vote (whether present or not) for an unlisted REIT.[10]

This can be a cheaper and speedier approach for an acquirer that wishes to take over control of the management of a REIT (rather than ownership of the REIT's securities) or could be used in combination with acquiring a material stake in the REIT securities.

The challenge is typically demonstrating to existing investors that the proposed replacement responsible entity offers a more compelling proposition than the incumbent. While such action is possible on relatively low voting thresholds, in practice it is very rare that a responsible entity is forcibly removed in this way.

iii Hostile transactions

Activity in relation to ASX-listed REITs can be hostile. While the majority of transactions are negotiated to a position where both parties are supportive, this is not always possible and it is not uncommon for REITs to become subject to competing bids once they are in seen as being in play.

More recent examples in the Australian market include the bid by 360 Capital Industrial Fund for the Australian Industrial REIT in 2015 and the ongoing activity in relation to the GPT Metropolitan Office Fund.

For a hostile bidder, the preferred mechanic is generally an off-market takeover bid, as the schemes process becomes unwieldy without cooperation of the target board (given, in particular that, the target is responsible for management of the scheme process and for obtaining security holder approvals).

Issues and challenges for bidders in these circumstances are common in hostile public markets transactions generally, including:

a gaining access to due diligence – while listed REITs have a general obligation under the ASX Listing Rules to disclose to the market materially price-sensitive information, there are various carve-outs including in relation to confidential incomplete proposals;

10 Section 601FM of the Corporations Act.

b relatively high compulsory acquisition thresholds – generally 90 per cent of acceptances are needed;

c determining appropriate bid conditions, particularly the level of required acceptances and when it may be appropriate to waive these to seek to encourage further acceptances;[11]

d potential approaches to the Australian Takeovers Panel on aspects of the bid, which can affect deal timing – for example, in the *360 Capital* case, an application was made to the Takeovers Panel to have certain statements in the bidder's statement declared misleading; and

e more generally, hostile processes are often protracted and played out in the media attracting significant scrutiny of the parties involved.

In considering strategies for defending against hostile bidders, REIT trustee directors need to comply with their statutory and fiduciary duties, including in particular the duties that any action be for a proper purpose and in the interests of the REIT's security holders. ASX Listing Rules prohibit certain issues of securities within three months of a takeover announcement and the Takeovers Panel may declare a range of target actions to frustrate takeover activity as unacceptable. Asset lock-up arrangements (such as call options over key REIT assets) are generally uncommon and may be declared unacceptable by the Takeovers Panel if not disclosed or approved by security holders.[12] US-style takeover defence arrangements, such as poison pills, are not available to target boards in Australia.

iv Financing considerations

Financing approaches for Australian real estate transactions are primarily influenced by the type of transaction and proposed borrower.

Types of property finance

Real estate financing transactions are broadly divided into investment finance, development finance and portfolio finance.

Investment finance involves financing the acquisition of land or a completed development or building. The key categories of asset are commercial office buildings (including mixed use or retail space), shopping centres, industrial or manufacturing sites, and hotels and leisure sites. The financing may be of a 'single asset' or, more recently, the acquisition of an asset portfolio, which may include multiple office buildings, retail spaces and car parks, including by private equity sponsors. For 'single' asset investments, financing is typically bilateral from one lender with first-ranking security. For acquisitions of asset portfolios, financing is typically provided on a first-ranking secured syndicated basis.

Development finance involves financing the construction of a building or development, such as a commercial tower, apartment building or multi-use development. The key categories of asset are commercial office buildings, industrial and residential subdivisions,

11 Relevant to REITs, as the responsible entity of a listed scheme can be replaced by a 50 per cent majority vote of security holders, this can conceptually allow a bidder to gain a level of control over the REIT at a lower acceptance level (as was the case in the 360 Capital bid for the Australian Industrial REIT).

12 See Takeovers Panel Guidance Note 7: Lock-up devices.

apartment towers, multi-use developments, retail, and health and aged care facilities. This type of financing is typically secured senior debt provided on a 'club' basis, and may have some secured second-ranking mezzanine financing.

Portfolio finance involves financing for a REIT or listed or unlisted real estate fund to be used for general corporate or trust purposes, often including 'bolt-on' acquisitions. This type of financing is typically senior debt provided on a syndicated basis, and has more recently also included a mixture of bank debt and capital market financing, and may be secured or unsecured depending on the creditworthiness of the borrower group, the size and nature of the portfolio, and the level of gearing.

Funding sources

The trend for the cost of debt funding for real estate transactions has generally been upwards in recent times. While there is still strong appetite for good credit, this has also been combined with a falling appetite among domestic banks for construction and development financing for large residential developments, largely in response to a perceived oversupply of inner city apartment developments in the capital cities.

The importance of alternative funding sources has increased in light of the more subdued appetite of the domestic banks, and funding from non-bank sources is becoming more prevalent with mezzanine debt and also senior debt.

Senior debt is typically limited-recourse debt provided by one lender or a syndicate of lenders. The senior lenders take first-ranking registered security over the key real estate and other assets of the borrower, and the shareholders or unit holders of the borrower, to secure the senior debt.

The majority of transactions are financed using senior debt provided by at least one of the Australian domestic banks.

As noted above however, while most Australian banks are keen to lend to experienced sponsors and developers, there has more lately been a trend, particularly for development financing, towards tighter lending criteria for the major players. There is also an increasing appetite from offshore investors buying into the Australian real estate market.

As a result, an increasing number of deals are being financed by senior debt from offshore banks, particularly the Asian banks supporting the investment of their customers into the Australian market, and life or specialised investment funds. It is likely that this trend will continue.

Subordinated or mezzanine debt ranks ahead of equity or 'sponsor/parent' debt but behind senior debt. The margins and fees on third-party subordinated or mezzanine debt are typically significantly higher than for senior debt, and generally the subordinated or mezzanine debt is required to be drawn down prior to or simultaneously with the senior debt.

The use of subordinated or mezzanine financing has been most commonly used for development financing, particularly where the sponsors or parent are unable to fund the equity necessary to achieve the loan-to-value ratio, debt-to-equity ratio or cost-to-complete test imposed by the senior lenders. A trend is beginning to emerge, however, for mezzanine debt to be used for investment finance, particularly due to a tightening of the loan-to-value ratio requirements of senior debt lenders.

Typically, the key providers of mezzanine debt have been life funds or specialist investment funds, although increasingly offshore global investment funds and private equity sponsors are becoming active as mezzanine lenders.

Debt capital markets (bonds, notes, private placements and other debt securities) have been used as a funding method by REITs to obtain longer tenor and to diversify funding sources. The availability of funding in the US debt capital markets, particularly US private placements, has become a significant source of debt funding for REITs in more recent years. This form of financing does not tend to be used for investment or development financing, but is more prevalent for established funds with an existing portfolio of real estate assets.

Sponsors or parents of the borrower are typically required by senior lenders to inject some equity into the borrower, which may be in the form of actual equity or subordinated debt that is contributed prior to the senior debt and fully subordinated to the senior debt and the subordinated or mezzanine debt (if any).

Security

Security requirements depend on the type of finance sought.

Typically, security is required by senior lenders and subordinated or mezzanine lenders for investment or development finance. The senior lenders will require first-ranking security, and the subordinated or mezzanine lenders will require second-ranking security over the same assets, with an intercreditor arrangement regulating the priority of the securities and rights of the mezzanine lenders to enforce their second-ranking security. See further below on intercreditor arrangements.

Lenders will usually require:

a security over the real estate assets being acquired or developed and all of the assets of the investor or borrower including real property mortgages (requiring side deeds with the applicable landlord if the land is subject to a lease);

b security over the shares or units in the investor or borrower, which will, *inter alia*, restrict the parent's ability to deal with or encumber those shares or units without the consent of the lenders;

c in the case of development finance, a guarantee from the parent company (often to cover cost overruns or any interest shortfall) together with tripartite agreements with the builder and the developer; or

d in the case of investment finance of a commercial or retail tower, a tenant side deed with any cornerstone tenants.

Lenders do not usually have recourse to any other assets of the parent or sponsors.

Portfolio financing is either secured against the assets of the REIT group members or is unsecured, the extent of the security often being determined by the creditworthiness of the borrower group, particularly the gearing of the REIT, and in each case is supported by guarantees from the REIT group members. Typically, the margins and fees for secured group financings are lower than for unsecured group financings, but there is less freedom allowed to the members of the REIT group under the terms of the financing documents.

Where portfolio finance is provided on a secured basis, the lenders will require guarantees and first-ranking security over all of the assets of each REIT group member, including real property mortgages over interests in land to secure the loan. While there is typically more flexibility provided in a portfolio-style financing than investment or development financing, the usual 'security'-style covenants still exist.

Where portfolio finance is provided on an unsecured basis, lenders will require guarantees from each group member and negative pledges restricting the granting of security over any of their assets. In these circumstances the financing typically involves a combination of bank debt (provided on a syndicated and bilateral basis) and capital markets debt, in each case with the same covenant package (being representations, undertakings and events of default) set out in a common-terms deed from which all of the financiers benefit. Typically, the financing is provided on a 'corporate'-style basis, which offers more flexibility and a less stringent covenant package.

There is a current trend for REITs and real estate funds to move from secured funding to unsecured to provide the group with greater access to other sources of funding such as debt capital markets, which is typically undertaken on an unsecured basis.

Intercreditor arrangements and mezzanine holding company debt

Typically mezzanine debt has been used by developers to secure supplementary financing, and such debt has been provided directly to the borrower and secured by second-ranking security over the assets subject to the first-ranking security granted to senior lenders.

For some time Australian domestic banks have been reluctant to accept capital structures with multiple tiers of debt, due in some part to the rights being sought and negotiated by mezzanine lenders (including rights to enforce, standstill periods and restrictions on senior refinancing) and the practicalities of enforcement.

In more recent times, however, there have been a number of deals executed involving mezzanine debt at the holding company level. These instruments, which are structurally subordinated to senior debt, have often featured 'payable in kind' interest together with an equity stake in the form of a conversion feature (somewhat similar to a convertible bond), such that the mezzanine lender can get the benefits of preferred equity and secured debt.

This arrangement is increasingly accepted by senior lenders, and is in some respects a preferred structure because of the structural subordination of the mezzanine debt.

General terms

There are a number of terms that have been imported from the leveraged finance market and are being applied to terms of property financing, including the loosening of general covenants and use of materiality qualifiers.

Recent trends also include the use of a 'certain funds regime' for property investment financings, and an 'equity cure' for breaches of financial covenants (such as the loan-to-value ratio) across property financings generally.

v Tax considerations

Income tax – characterisation of disposals

The disposal of interests in a real estate-holding entity gives rise to either a taxing event (on revenue account) or a capital gains tax (CGT) event (on capital account). The distinction determines if a security holder can access the CGT discount and CGT roll-over relief, and ultimately affects the security holder's tax rate.

An investment is generally considered to be held on revenue account where it was made for a profit-making purpose through the sale of an interest, rather than for holding over the medium to long term as a 'passive' investment. Where an investment is held on revenue account, the investor is subject to tax on any excess in proceeds received over the cost of acquiring the relevant interest. Investments held on revenue account do not enable the investor access the CGT discount, nor is CGT rollover relief available.

If acquired for the holding over the medium to long term as a 'passive' investment, an investment will generally be considered to be held on capital account, and subject to CGT rules, in which case:

a a capital gain would normally arise where capital proceeds received by a security holder exceeds the security holder's cost base in its investment; and

b a capital loss arises where capital proceeds received by the security holder are less than the security holder's cost base in its investment.

Capital proceeds comprise cash considerations as well as the market value of any securities or other property received on disposal of the relevant asset.[13]

The security holder's cost base in an investment is, broadly, the original amount paid to acquire that investment, plus any incidental costs incurred on the acquisition or disposal of that investment.[14] Where the investment being disposed of is units in a trust, distributions paid on those units that have been sheltered from tax by way of non-cash tax deductions (for example, depreciation on buildings and plant) are not taxed when received, but rather reduce the cost base in those units.[15]

Generally, unit holders who are individuals, trusts or complying superannuation funds can offset capital losses against current or future year capital gains. This is also the case for companies, if specific loss recoupment rules are satisfied.[16]

Australian-resident individuals, superannuation funds and trusts that have held an investment for more than 12 months are entitled to reduce their CGT gains by a CGT discount. Resident individuals and trusts are entitled to a 50 per cent discount on CGT and complying superannuation entities a 33.3 per cent discount.[17]

The CGT discount is not available to non-residents. However, non-resident security holders are only subject to CGT on the disposal of units or shares if, broadly:

a the non-resident security holder (together with any associates) did not hold a 10 per cent or more interest in the relevant REIT or the company for a 12-month period that began no earlier than 24 months before that time; or

b no more than 50 per cent of the value of the REIT or the company derives from direct or indirect interests in Australian real property.[18]

13 Division 112 of the Income Tax Assessment Act 1997 (Cth).

14 An investor's cost base in a share or unit is determined by applying the rules in Division 110 of the Income Tax Assessment Act 1997 (Cth).

15 See Section 104-70 and 104-71 of the Income Tax Assessment Act 1997 (Cth).

16 These rules require the company to have maintained continuity of ownership from the beginning of the year the loss was made to the end of the year it is used; or to have maintained the same business from the time of any continuity of ownership failure to the end of the income year the loss is utilised: Division 165 of the Income Tax Assessment Act 1997 (Cth).

17 See Division 115 of the Income Tax Assessment Act 1997 (Cth).

18 Division 855 of the Income Tax Assessment Act 1997 (Cth).

As REITs generally hold direct or indirect interests in Australian real property, only the first test above would be relevant to non-resident security holders. In some circumstances, companies stapled to REITs do not meet the 50 per cent real estate threshold,[19] and so both tests could be relevant.

Holding structures

Most REITs are structured as managed investments trusts (MITs) (or seek to include an MIT in any stapled structure). A specific tax regime designed for MITs provides certain tax benefits for REITs, with the policy intent of promoting Australia's funds management industry and its collective investment vehicle-management expertise. As a result, whether MIT status will be available is usually a key consideration in structuring real estate investment transactions.

To access the MIT regime, a trust needs to satisfy certain ownership criteria and be managed by a holder of an Australian financial services licence.[20]

The key benefits of accessing the MIT regime are:

a for non-resident investors, lower withholding tax rates can apply to distributions of income by an MIT throughout the life of the investment, and also on any gain on disposal;[21] and

b for Australian-resident investors, investments made by an MIT automatically become subject to the CGT rules (and are not taxed on revenue account) when the MIT makes a 'CGT election'.[22] This enables access to the CGT discount and CGT rollover relief.

Accordingly, where the investor mix and investment type lends itself to an MIT structure, this is generally the structure that is used.

Availability of scrip-for-scrip rollover relief from CGT

Scrip-for-scrip rollover relief from CGT may be available where units in a REIT or shares in a company are disposed of in exchange for units or shares.[23] Transactions are often structured to allow for scrip-for-scrip rollover as it allows a security holder to defer any gain made on the transaction until the replacement units or shares are eventually sold.

The key requirements that must be satisfied to access scrip-for-scrip rollover relief are as follows:

a Shares must be exchanged for shares, and units for units. In many cases, an offshore acquirer or target will only be a trust or a company. If the target or acquirer is not the same type of entity, or is a stapled group consisting of a trust and a company, this requirement cannot be met, or may be only partially met (by a stapled group).

19 For example, companies in stapled groups might undertake development activity on land owned by others, and such rights under a development contract are not interests in real estate.

20 For the requirements to be an MIT, see Subdivision 275-A of the Income Tax Assessment Act 1997 (Cth).

21 Subdivision 12-H to Schedule 1 of the Taxation Administration Act 1953 (Cth).

22 Subdivision 275-B of the Income Tax Assessment Act 1997 (Cth).

23 Subdivision 124-M of the Income Tax Assessment Act 1997 (Cth).

b The acquiring entity must become owner of 80 per cent or more of the target entity. In some cases, the threshold for a scrip offer to become unconditional is lower. It can be the case that not enough approvals are met to reach the 80 per cent threshold, meaning that security holders accepting the offer do not receive rollover relief.

c Where the transaction is a unit-for-unit transaction, each trust must be a 'fixed trust'. The law as to what constitutes a fixed trust is unclear, so the Commissioner of Taxation's discretion to treat trusts as 'fixed trusts' is almost always sought. Under recent changes to the MIT rules, trusts that are MITs may be automatically deemed fixed trusts if certain requirements are met.

d The offer must be on substantially the same terms to all security holders in the target entity, so that, for example, significant security holders cannot be treated differently to other security holders.

e For foreign-resident security holders, the replacement interest must also be 'taxable Australian property'. Where a larger entity acquires a smaller entity, a foreign resident's interest in the target may be over the 10 per cent threshold (and thus 'taxable Australian property' and subject to CGT, but the interest in the larger entity may be below the 10 per cent threshold (and thus, not 'taxable Australian property'), meaning the rollover does not apply to that security holder).

Income tax – anti-avoidance

Australia has a general anti-avoidance rule, which provides that where a transaction is structured for the sole or dominant purpose of reducing Australian income or withholding tax, the Commissioner of Taxation has the power to assess tax on the basis of a reasonable counter-factual (that is, what the structure or transaction would have been without the tax avoidance purpose).[24] Where the anti-avoidance regime is applied, the taxpayer is also generally subject to penalties and interest, in addition to the primary tax that has been avoided. Accordingly, it is important that there be robust commercial reasons for using an investment structure (and any steps within a transaction).

Stamp duty and land tax

Acquisitions of Australian real estate assets attract state and territory stamp duty. Duty in relation to acquisitions of commercial land generally ranges from 4.5 per cent to 5.75 per cent of improved land value (or purchase consideration if higher) depending on the state or territory in which the land is located.[25]

Duty applies not only to acquisitions of direct interests in land, but also to acquisitions of interests (usually above a certain threshold) in land holding trusts and companies.

24 Part IVA of the Income Tax Assessment Act 1936 (Cth).

25 See generally, Duties Act 1999 (ACT), Duties Act 1997 (NSW), Stamp Duty Act 1978 (NT), Duties Act 2001 (QLD), Stamp Duties Act 1923 (SA), Duties Act 2001 (Tas), Duties Act 2000 (Vic), Duties Act 2008 (WA).

State and territory annual land taxes may also be payable, subject to the availability of certain concessions. The top marginal land tax rates range between 1.5 per cent and 3.7 per cent (of the unimproved value of the land) depending on the state or territory in which the land is located.[26]

Higher duty and land tax rates apply to acquisitions of residential property in certain circumstances. Victoria, New South Wales and Queensland have, or are in the process of imposing, surcharges on foreign acquirers of residential real estate. This may affect the activities of foreign-owned real estate private equity firms engaged in residential development or repositioning, although at this stage the likely impact is hard to assess.

vi Cross border complications and solutions

Foreign investment regulation

Foreign investment in Australian real estate is regulated by the *Foreign Acquisitions and Takeovers Act 1975* (Cth). This legislation was substantially rewritten in 2015 and, in a number of respects, its application to foreign investment in Australian land remains unsettled.

Nominally, acquisitions of interests in land (including direct investments and investments in land-holding trusts and corporations) exceeding A$252 million are notifiable and must be approved by the Commonwealth Treasurer (as advised by the Foreign Investment Review Board (FIRB));[27] however, lower thresholds apply to a range of acquisitions:

a A threshold of A$55 million applies to certain classes of sensitive land. Because of the way the classes of sensitive land are defined, the lower threshold is likely to apply to most types of land in which foreign investors are likely to invest.[28]

b A threshold of A$15 million applies to acquisitions of agricultural land.[29]

c No monetary threshold applies to:
- most acquisitions of interests in residential land;
- most acquisitions of interests in vacant commercial land; and
- acquisitions of interests in Australian land by foreign government-related investors (including state-owned enterprises, sovereign wealth funds and many state-managed pension funds);

such that all such acquisitions must be notified and approved.[30]

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26 See generally, Land Tax Act 2004 (ACT), Land Tax Act 1956 (NSW), Land Tax Act 2010 (QLD), Land Tax Act 1936 (SA), Land Tax Act 2000 (Tas), Land Tax Act 2005 (Vic), Duties Act 2002 (WA), and various related administration and assessment legislation.

27 Section 81 of the Foreign Acquisitions and Takeovers Act 1975 (Cth); section 52(5), Foreign Acquisitions and Takeovers Regulation 2015 (Cth). The monetary are indexed annually. The thresholds set out here apply as at the date of publication.

28 See Section 52(5) and (6) of the Foreign Acquisitions and Takeovers Regulation 2015 (Cth). For example, the lower threshold applies to acquisitions of certain types of interests in land under 'prescribed airspace'. Most of the land in the commercial centres of Australia's capital cities is situated under prescribed airspace.

29 Section 52(4) of the Foreign Acquisitions and Takeovers Regulation 2015 (Cth).

30 Section 52(1) of the Foreign Acquisitions and Takeovers Regulation 2015 (Cth).

A higher A$1.094 billion threshold applies to certain direct investments by foreign investors from countries with which Australia has a free trade agreement, although in practice, this threshold is rarely available.[31]

The legislation provides a 30-day period from the date lodgement fees are paid within which a decision whether to approve the acquisition is made; however, particularly for sensitive or complex transactions, this period is often extended. Acquisitions are reviewed on national interest grounds, with the FIRB receiving input in relation to proposed acquisitions from a range of government agencies, including the Australian Taxation Office, and national security agencies before providing its advice to the Treasurer. Approval is required before the acquisition can complete.[32]

Taxation

Investment income paid to foreign investors in Australian land-owning vehicles is generally subject to Australian withholding tax (generally 10 per cent for interest, 30 per cent for unfranked dividends and up to 49 per cent for trust income distributions). Lower withholding rates may apply in certain circumstances pursuant to double taxation agreements.

Concessional withholding tax applies to income distributions by trusts that satisfy the conditions for being characterised as an MIT for tax purposes (see Section IV.v, *supra*, for more detail).

While interest is subject to a maximum 10 per cent withholding tax, thin-capitalisation rules generally apply to disallow tax deductions for the entity paying the interest where leverage exceeds 60 per cent of the value of the underlying assets, which increases the overall effective tax rate. Other transfer pricing rules apply to prevent payment of non-arm's-length fees to offshore entities.

V CORPORATE REAL ESTATE

Separation and spin-off or securitisation of real estate assets by real estate-heavy corporations has, until recently, occurred on a sporadic basis in the Australian market. More typically, balance sheet real estate assets would be realised through sale and lease-back arrangements to already established specialist property funds.

A variety of separation structures have been used to realise the value inherent in corporate real estate portfolios:

a internally-managed ASX-listed REITs (eg, Shopping Centres Australasia Property Group, spun off by Woolworths in 2012 and the Asia Pacific Data Centres Group, spun off by NextDC in 2013);

31 Section 52(5) of the Foreign Acquisitions and Takeovers Regulation 2015 (Cth). Countries for which the higher threshold applies include the United States, New Zealand, Chile, Japan, South Korea and (once the Australia–China Free Trade Agreement comes into force) China. The higher threshold only applies where the investor domiciled in the relevant country acquires the relevant real estate interest directly rather than through an interposed entity. In practice, most investments are conducted through interposed entities.

32 Sections 77 and 82 of the Foreign Acquisitions and Takeovers Regulation 2015 (Cth).

b externally managed ASX-listed REITs, with the manager being the corporation that was spinning off its real estate assets (eg, the BWP Trust, spun off by Wesfarmers in 1998); and

c property-linked notes (Westfield Group in 2007 and Wesfarmers in 2013) placed with specific institutions or offered more widely in the wholesale debt capital market.

Recently, particularly as the listed property market has gained momentum in Australia, there has been renewed interest in separation and spin-off of real estate assets. A number of separations and spin-offs have been announced for 2016, including the Viva Energy REIT, comprising a portfolio of service station sites leased back to Viva Energy, and the proposed Crown Resorts demerger and spin-off of a hotel property trust.

VI OUTLOOK

The recent performance of listed property is increasingly encouraging owners of real estate assets to release additional stock into the public markets, with a number of REIT IPOs scheduled for the upcoming year. Also, the externally managed listed fund structure, which fell out of favour following the financial crisis of 2007–2008, is making a comeback.

It is expected that current uncertainties as to how the new foreign investment regulatory regime applies to real estate transactions are likely to be settled, either through regulatory clarification or development of market practice.

Chapter 3

BRAZIL

Henry Sztutman and Flávio Coelho de Almeida[1]

I OVERVIEW OF THE MARKET

As a starting point it is important to note the macroeconomic environment in Brazil going into the second half of 2016. President Dilma Rousseff was removed from office in September by a vote of the Senate. Her Vice President Michel Temer has succeeded her for the remainder of her term and has changed the team in charge of economic policy, but Brazil is struggling with recession, and the country's economy is expected to shrink further in 2016. The confidence of industry players, consumers and investors remains weak, and the country's economic downturn has taken a heavy toll on the real estate market. Credit remains scarce and expensive in Brazil. Interest rates are abysmally high, and so are the inflation and unemployment rates. Within this gloomy scenario, there are some specific cases of debt-ridden real estate companies and distressed assets, so real estate asset prices are generally low, which translates into an opportunity for attractive investments in the eyes of foreign investors. In brief, there are great opportunities for high returns at acceptable risk levels for those with appetite and awareness for doing business in Brazil.

Foreign investors have shown keen interest in the medium and large-scale real estate deals with high-investment tickets, comprising housing projects in small and large urban centres for all social classes; office building and shopping centre projects; self-storage warehouses for industry, agribusiness and logistics use; and land intended for agribusiness use. Also relevant are real estate funds investing in infrastructure undertakings in general, such as electric power transmission lines.

In recent years, real estate operating companies (REOCs) acting in the residential segment in Brazil have been hard hit, and a good deal of them are experiencing liquidity problems. In this challenging environment, they are focusing on survival by making cash through inventory sales, even at the expense of their yield and profitability margins. Several REOCs are putting

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off the launch of new projects. Faced with this unfavourable scenario, a great many consumers have opted to undo deals and return committed units. Some of those REOCs are listed on the São Paulo Stock Exchange (BM&FBOVESPA), and their market caps have hit record lows in recent months and years, matching the country's economic downturn.

At the investment end, some key real estate industry players in Brazil are Blackstone, Pátria,[2] Brookfield, Canada Pension Plan Investment Board (CPPIB), Hines, Gazit and Kinea. These all have offices and teams in Brazil, and manage substantial investments in the real estate industry, attracted by the fact that medium and large real estate deals are flourishing in Brazil, several of them being announced in recent months. Those investors have recently made good deals by absorbing or buying strategic assets (shopping centres, warehouses, commercial buildings) at bargain prices.

One of the reasons for this buying trend lies in the local economic instability, which has prompted some of the country's debt-saddled REOCs (BR Properties and PDG Realty, *inter alia*) to sell strategic assets and restructure their debts. Those companies have used sale proceeds to strengthen their cash flow, pay dividends to shareholders, and reduce their net debt.

Some real estate investors in Brazil opt for direct acquisition of real properties or real estate-backed securities. Others acquire stocks of listed REOCs.

The presence of those more sophisticated long-term investment players in the local real estate market has bolstered the sophistication of real estate deals in Brazil, including an increase in the issuance of real estate receivables certificates (CRIs) and other real estate-backed securities and in underlying receivables. On top of that, the Brazilian Securities and Exchange Commission (CVM) regulations have also imposed more complex corporate governance standards on companies and funds acting in the real estate industry.

The Brazilian legal system is based on the Roman-Germanic tradition, which means that the core principles of law are always codified. The Brazilian tax system is extremely complex, and several layers of constitutional, federal, state and municipal laws and regulations unfold cumulatively; hence, a deep understanding of the tax implications for every project is critical to investment decision-making in Brazil. The courts usually take years to render a final and conclusive decision on how a law or regulation should be construed in a specific circumstance, but such decision is enforceable only on the parties to the dispute. In other words, court rulings serve as a guide, but are not binding on all market players.

From a legal perspective, the key issues in acquiring real estate in Brazil are:

a development of the most advantageous structure for the deal, taking into account such issues as liability and tax efficiency for investors;

b conveyance tax considerations;

c legal restrictions on acquisition of Brazilian real property by foreigners;

d environmental and consumer law issues;

e the impact of specific laws related to real estate development and lease activities;

f tax and labour issues at the operating company's level, which affect the company's results and, by extension, investor returns.

2 In 2010, Blackstone took a 40 per cent stake in Pátria.

II RECENT MARKET ACTIVITY

i M&A transactions

No IPO involving real estate companies has been made in Brazil in recent years. The last real property company to go public was Sonae Sierra in 2011. In Brazil, IPOs boomed in 2006 and 2007, and most REOCs went public in those years.

GP Real Properties' acquisition of control of BR Properties

In a sophisticated takeover bid, GP Real Properties gained control of BR Properties by acquiring a 70 per cent common shareholding stake under a tender offer governed by CVM Ruling 361 of 2002.

This tender offer was subject to certain conditions:

a the holders of a certain minimum volume of shares needed to express their unconditional acceptance of the bid;

b the general meeting of BR Properties needed to consent to a waiver of the poison pill mechanism set out in the by-laws of BR Properties;

c financial institutions and the holders of debentures or other debt securities of the target company needed to formally consent to a waiver of the right to trigger any acceleration clause; and

d certain material adverse changes need to have not occurred.

On these conditions being satisfied in a timely manner, GP Real Properties gained control of BR Properties on 11 May 2016. The tender offer value reached 1.896 billion reais. After closing of this deal, BR Properties remained listed on BM&FBOVESPA, in the Novo Mercado trading segment. This was the closest ever to a hostile takeover bid in the Brazilian M&A market involving a listed real estate company, as some directors of BR Properties stood against the tender offer itself and its proposed price until the last minute. One discouraging factor to hostile takeover bids on BM&FBOVESPA is that in the Brazilian securities market, the by-laws of several listed companies in Brazil have non-negotiable provisions and poison pill clauses by which an investor reaching a certain threshold (say, 15 per cent, 18 per cent, 20 per cent or 25 per cent) is required to make a tender offer at a price per share well above market value. This was the very reason why GP Real Properties requested, as one of the conditions for its tender offer, that the general meeting of shareholders should expressly waive the poison pill clause set out in the by-laws of BR Properties. Had such waiver not been given, the deal would have been shut down.

Acquisition of industrial warehouses by Singapore-based Global Logistic Properties Limited

This large deal (worth around 3.18 billion reais) was announced in June 2014. Other such asset sales have been made by BR Properties recently, as further addressed in Section II.ii, *infra*.

Acquisition by LDI of equity interest held by PDG Realty in REP Real Estate Partners

The target company engages in advisory, management and development of shopping centres and service or office centres. In consideration for an equity interest held by PDG Realty in REP Real Estate Partners, LDI delivered to PDG Realty 26 real property units located in the city of São Paulo and worth approximately 33.868 million reais, which were owned by an LDI-controlled entity. This deal reduced PDG Realty's consolidated net debt as of

31 December 2015 by approximately 237 million reais, and was announced on 4 May 2016. On that same date, PDG Realty also announced that it had executed a restructuring memorandum with banks worth 3.7 billion reais (60 per cent of its gross debt). This was meant to reschedule its debt and give the company some breathing space to avoid selling off its inventory under pressure and at any cost. Should the company manage to sell its assets at fair market value and use a portion of the proceeds to reduce its debt principal and interest, with a possibility of even offering some real property assets to banks as a way of reducing its debt burden, the creditor banks could consider opening new credit facilities that would enable the company to complete works in progress and obtain some working capital. Both deals were part of a more complex transaction involving the PDG Realty's pursuit of a sounder financial balance by reaching an agreement with creditor banks and concurrently selling some assets based on a legally effective structure entailing the PDG Realty's sale of equity interests in a special purpose entity holding those assets.

ii Private equity transactions

Acquisition of BR Properties assets by Brookfield

It was announced on 21 June 2016 that BR Properties and Brookfield had entered into four real property purchase commitments and a stock purchase agreement by which Brookfield would acquire real estate assets in the cities of São Paulo and Rio de Janeiro, as well as equity holdings held by BR Properties. The deal value was around 2.079 billion reais.

Acquisition of interest in the Jardim das Perdizes undertaking by Hines

The acquisition by Hines of the total interest held by PDG Realty in the Jardim das Perdizes undertaking for 160 million was announced in October 2015.

Acquisition of BR Properties assets by Blackstone through BRE Ponte Participações

This deal refers to 10 leasable property assets comprising industrial and logistics warehouses, as well as office buildings owned by BR Properties, which were acquired by BRE Ponte Participações (a special purpose entity owned by Blackstone) for 1.065 billion reais. The deal was announced in August 2015.

Acquisition of IFF Opportunity managed assets by Blackstone and Pátria.

This deal refers to acquisition of four commercial buildings in Rio de Janeiro for 700 million reais. The deal was announced in December 2014.

Acquisition by Blackstone and Pátria of a stake in Alphaville Urbanismo by da Gafisa

The acquisition by Blackstone and Pátria of a 70 per cent stake in Alphaville Urbanismo by da Gafisa for 1.4 billion reais was announced in 2013. This deal refers to an urban development undertaking near the city of São Paulo.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Publicly traded real estate investment trusts (REITs) existing and organised under Brazilian law are not at all common in Brazil. Instead, real estate investment funds (FIIs) and private equity funds (FIPs) are currently the two most popular and tax-efficient structures that investors use as vehicles for their real estate investments in Brazil.

Real estate operating companies (REOCs) are quite popular in Brazil. There is a plethora of REOCs of varying sizes and purposes in Brazil, most of them being organised as closely held companies, but a few being publicly held companies traded on BM&FBOVESPA.[3]

REOCs are for-profit companies that pay standard corporate taxes in Brazil, as opposed to FIPs and FIIs, which are investment vehicles designed to receive and carry out investments under a more favourable tax treatment for the benefit of their investors.

FIPs usually invest directly in shares of a company (acting in the real estate business or in other markets), including closely held and publicly held REOCs. FIIs, however, usually invest directly in real estate assets by means of acquisition of the property itself or real estate-backed credits. Under CVM Ruling 472, all companies receiving FII investments via real estate-backed securities must be registered with the CVM. Most Brazilian REOCs listed on a stock exchange and issuing real estate-backed securities must have adhered to senior corporate governance trading segments (almost all of them on BM&FBOVESPA's Novo Mercado).

ii Real estate PE firms – footprint and structure

As previously mentioned, some of the most relevant real estate private equity firms in Brazil are Blackstone, Pátria (in partnership with Blackstone), Brookfield, CPPIB, Hines, Gazit, and Kinea. All of these firms have offices in Brazil and a local staff composed of real estate experts. A typical structural challenge that applies to every international private equity firm establishing an office and team in Brazil refers to the corporation type and compensation package to be adopted locally. The intricacies of the Brazilian tax system are such that it is very often preferable to set up a Brazilian company (as subsidiary of a foreign-based parent company), which will be in charge of providing services, hiring the necessary staff, and paying the monthly compensation and annual bonuses to personnel. The partners in such Brazilian companies are usually the most senior executives acting in Brazil, and operating expenses are charged to investment advisory service revenues.

If services are hired and paid for by a foreign-based related person, then transfer pricing rules apply. Another complex issue relates to the partner or employee status of the local team. Partners enjoy a more favourable taxation of profits and dividends as opposed to the high labour and social security costs on wage earners. For this reason, senior managers tend to

3 Such as Aliansce (www.aliansce.com.br), Iguatemi (www.iguatemi.com.br), São Carlos (www.scsa.com.br), General Shopping (www.generalshopping.com.br), BR Malls (www.brmalls.com.br), Multiplan (www.multiplan.com.br), BrasilBrokers (www.brasilbrokers.com.br), Rossi (www.rossiresidencial.com.br), MRV (www.mrv.com.br), Helbor (www.helbor.com.br), EZTEC (www.eztec.com.br), LPS (www.lopes.com.br), Even (www.even.com.br), Direcional (www.direcional.com.br), BR Properties (www.brpr.com.br), PDG Realty (www.pdg.com.br), Gafisa (www.gafisa.com.br), Sonae Sierra (www.sonaesierra.com.br), JHSF (www.jhsf.com.br), Cyrela (www.cyrela.com.br), Viver (www.viver.com.br), Beter (www.beter.com.br), LDI (www.grupoldi.com.br), CR2 (www.cr2.com.br), João Fortes (www.joaofortes.com.br), Trisul (www.trisul-sa.com.br). Please refer to the respective websites mentioned above to check history, profile, strategy, competitive advantages, portfolio, governance and other corporate and investor-related matters of the most relevant REOCs currently doing business in the Brazilian market.

make as many staff as possible into partners (non-employees), but from a legal perspective it is important to treat staffers with regard to their actual roles and responsibilities, the costs inherent to each being defrayed accordingly.

Another dilemma lies in the income that the Brazilian team will receive from the foreign-based parent company, whether as a monthly or annual compensation, or as a 'carry' upon realisation of divestiture gains. Such aspects and respective solutions should be considered on a case-by-case basis, in light of the tax and asset condition of each individual involved.

IV TRANSACTIONS

i Legal frameworks and deal structures

The most important laws are the Civil Code and the Brazilian Corporations Law. Extensive regulations from the CVM and from BM&F BOVESPA also apply to publicly held companies adhering to specific corporate governance segments. CVM regulations also apply to investments made by FIPs. Transactions are generally structured via special purpose vehicles (SPVs) (as this gives more liquidity to real estate assets). A more detailed explanation follows on legal frameworks and deal structures for real estate transactions in Brazil.

There are a number of ways in which to invest in real estate in Brazil, such as: (1) direct investment in real estate; (2) SPVs; (3) FIIs; and (4) FIPs. Each alternative presents pros and cons depending on the purpose of the investment, funding structure, governance, tax impacts, among other criteria.

Direct investment in real estate

There are currently no restrictions on the direct acquisition of urban property in Brazil by a foreign individual or legal entity.[4] The standard deal usually follows the steps below:

a Initial agreement between seller and buyer: the parties execute a preliminary agreement, usually covering (1) the buyer's right to access certain documents on the property and on the seller; (2) the seller's obligation to make such documents available; (3) specific due diligence rules and timelines; (4) an exclusivity period; and, sometimes even (5) a down payment. Typical non-binding documents executed at this stage are letters of intent or memoranda of understanding encompassing a limited number of rights and obligations of each party.

b Purchase and sale commitment: one of the most typical conditional purchase agreements is the purchase and sale commitment (commitment), by which the parties agree that, once certain pre-requisites are satisfied (e.g., full payment of the real estate price or satisfactory due diligence results), the buyer is required to acquire the property and the seller is required to sell it. This commitment is executed before the public deed of title is drawn up, and usually involves a down payment by the buyer.

c Completion of the deal: once the terms and conditions of the commitment have been fulfilled or waived, the parties execute a public deed of title before a notary public, usually against full payment of the purchase price and of property transfer tax (ITBI,

4 As further explained below, there are currently restrictions on acquisition and lease of rural properties by foreigners.

which varies from 2 to 5 per cent, depending on the location). Execution of this public deed of title involves notary costs calculated at the transaction value or assessed value, whichever is higher.

d Registration of the deed: under Brazilian law, title to real property is usually conveyed by means of a transfer deed, which is subsequently registered with the competent real estate registry office upon annotation in the corresponding property record. Such registration is necessary to meet the formalities inherent to such type of document; disclosure of real property conveyance must be arranged so that it is enforceable on third parties. Acquisition of the real property is completed by transfer of title.

Special purpose vehicles

The most common ways for foreign investors to invest in the Brazilian real estate market are by: (1) forming a local legal entity (a joint-stock company or a limited liability company) to own real estate or develop real estate projects; and (2) setting up an FIP.

Brazilian law provides for several forms of business organisations, with the most widely adopted being the limited liability company and the joint-stock company. These two companies have some features in common and also share basically the same tax treatment, but limited liability companies are less bureaucratic and expensive than joint-stock companies.

Whatever the form adopted, these two companies have some features in common. First, there must be at least two partners (shareholders or members), which may be individuals or legal entities that need not be domiciled in Brazil. In principle, there are no minimum capital requirements for the organisation of such companies; the capital stock may be allocated between the parties at their own discretion.

ITBI is not levied when SPV equity holdings are sold, even if the SPV owns real property assets. However, ITBI will always be levied when the real property is sold to a third party.

All REOCs are organised as joint-stock companies, and their shares are traded on BM&FBOVESPA in the Novo Mercado trading segment. REOCs are subject to the Corporations Law, rules enacted by the CVM, their respective by-laws, and all governance rules, internal controls and corporate agenda set out in the Novo Mercado self-regulatory standards.

FIIs

According to Law No. 8,668 of 1993, further regulated by CVM Ruling No. 472 of 2008, FIIs are closed-end funds organised as unincorporated entities (condominiums), with no legal personality, through which joint ownership of real estate assets and securities is exercised.

Permitted investments are in:

a real estate properties and rights;

b equity of real estate companies;

c special purpose entities engaging in real estate business;

d other funds (FIPs, FIIs, FIDCs (i.e., receivables securitisation funds that must allocate over 50 per cent of their net assets to credit rights (including those credit rights attached to underlying real estate businesses or assets); and

e real estate receivables certificates and other instruments.

Investment funds do not have legal personality, but even so are still required to obtain a corporate taxpayer number (CNPJ).

FIIs are managed by administrators accredited by the CVM and hold fiduciary ownership of the portfolio assets. Administrators are also liable for payment of taxes by FIIs as and when due.

FIPs

According to CVM Ruling No. 391 of 2003, as amended, the FIP must be organised as a closed-end condominium consisting of an unpersonified pool of assets (as opposed to funds organised as partnerships or corporate entities) managed and represented by administrators registered with the CVM.

The FIP form can be especially attractive to private equity investors seeking lower individual exposure to risks through the gathering of funds by an investor pool and asset diversification. An FIP can also supply its owners with a platform for the centralised professional management of investees with the requisite market and financial skills that would otherwise not be available to investors acting individually or through subsidiaries.

Despite being an unpersonified entity, the FIP is also required by tax regulations to obtain a CNPJ and to book transactions in its own name and on its own behalf, as if it were an incorporated legal entity. Even so, the corporate tax enrolment of FIPs does not affect their unincorporated status and is required primarily for tax filings and reporting purposes.

The FIP can acquire shares (stock), convertible debentures, subscription warrants and other securities, either convertible into or exchangeable for shares issued by publicly or privately held corporations, the management of which must be actively monitored by the FIP. At least 90 per cent of the FIP's net equity must be allocated to such permitted investments. The remaining portion of the portfolio can consist of liquid fixed-income instruments (e.g., Brazilian treasury bonds) and other financial assets, mainly for cash management purposes.

Investments by the FIP in either closely or publicly held corporations are not subject to minimum revenue or net-worth requirements. Likewise, no mandatory concentration or diversification requirements would apply to the allocation of the FIP's portfolio in equity investments, unless otherwise stipulated in its by-laws.

ii Acquisition agreement terms

Whatever the structure adopted to invest in real properties in Brazil, the prospective buyer should always undertake a complete and detailed due diligence on both the property and the seller. The due diligence scope and criteria have a direct bearing on the avoidance of future problems relating to the property or to the purchase and sale transaction.

The due diligence may verify the existence of open issues (debts, suits and claims) concerning the target property or the seller, which could label the deal as a fraudulent sale and eventually vitiate the transfer of legal title.

Further, the buyer could use due diligence efforts as proof of its good faith in acquiring the property, which may help protect its ownership rights against third-party claims.

Besides a complete review of the documents related to the real property and its chain of title, a target property valuation is also advisable. This valuation is useful for business purposes, and also helps establish a fair value for the target property (which is thus being negotiated on an arm's-length basis, without any harm to the seller's creditors or to prior owners).

Based on due diligence findings, the buyer may ask for additional pre-closing measures, such as (1) a more robust set of guarantees; (2) supplemental representations and warranties; (3) allocation of a portion of the purchase price to an escrow account for some additional time; and even (4) a reduction in the purchase price.

Special attention should be paid to representations and warranties concerning specific real estate aspects (also addressing any existing burdens on the real properties concerned) with a resulting impact on indemnification rules and mechanisms. Further issues to be taken into account are the prerequisites possibly related to spin-off involving non-target assets, notably in the event an SPE structure to handle operating real estate assets was not put in place at the time of the original investment and, therefore, an SPE sale does not represent the best choice of deal structure in a particular situation.

The buyer may also give up on a deal if due diligence findings point to any serious issue that renders the property unfeasible for the intended business. Comprehensive due diligence encompassing not only real estate aspects but also environmental, tax and administrative circumstances can give a full picture of the property, its seller and other sensitive issues (indigenous or landless settlements, expropriation cases, etc.), which makes the buyer better equipped to balance the risk of claims against the target property.

iii Hostile transactions

Hostile takeover transactions do not tend to occur in Brazil, particularly because most REOC by-laws contain non-negotiable provisions or poison pill clauses by which a tender offer must be made at prohibitive prices (thus making hostile takeovers practically unfeasible).

iv Financing considerations

Real estate transactions are typically financed by means of the investor's own capital or through bank loans secured by a security package. Besides personal guarantees and guarantees tendered on company shares, the most common securities for real estate transactions in Brazil are mortgages and fiduciary liens.

Under Brazilian law, a mortgage is basically defined as a lien placed on a real estate or other immoveable property by a debtor (or its designee) as security for a debt owed to its creditor. If the debt is unpaid as and when due, creditors may bring suit to sell the mortgaged property and use the proceeds to pay the debt.

A fiduciary lien is a type of security interest by which the debtor transfers to the creditor conditional title to a certain property, holding for itself only physical possession of the property. The debtor recovers full title to and indirect possession of the property when the secured obligations are fully satisfied. If the debtor defaults, the creditor may arrange for foreclosure via out-of-court proceedings, which are carried out directly by the real estate registry office where the fiduciary lien is registered.

v Tax considerations

Under current tax regulations, foreign exchange transactions involving currency inflows or outflows associated with investments are generally subject to tax on foreign exchange transactions (IOF/FX), which is a tax triggered by settlement of foreign exchange (forex) transactions carried out by local or non-resident investors.

SPV taxation

Inbound forex transactions for acquisition of land (or for setting up a local SPV to that end) are generally subject to IOF/FX tax at a rate of 0.38 per cent. This also applies to repatriation of investments (upon sale of assets or capital reduction in Brazil). However, the distribution of profits (dividends and interest on net equity) is subject to IOF/FX tax at a zero rate.

In principle, direct purchase of lands by an SPV has no tax implications or risks other than those common to ordinary real estate negotiations. Generally speaking, an SPV must satisfy its obligations towards the seller as established in the corresponding purchase agreement, and also pay the ITBI tax at a rate varying from 2 to 5 per cent (depending on the municipality where the land is located).

Corporate income taxes

Upon future sale of the land, the SPV must pay corporate income taxes (IRPJ/CSL) on any positive results from fair value adjustments to the land price, but otherwise deferred for tax purposes. The tax rate varies depending on the IRPJ/CSL tax regime adopted by the SPV (the actual profits taxation regime or the estimated profits taxation regime).[5]

In Brazil, corporate taxation materialises in the form of corporate income tax (IRPJ) at a rate 25 per cent,[6] and a social contribution on net profits (CSL) at a rate of 9 per cent. With very few exceptions, these taxes are levied on the same tax base, which is why it is commonly said that the IRPJ/CSL taxes are levied at a combined rate of 34 per cent.

Under the actual profits taxation regime, a company's taxable profit is determined as the result of its actual revenues less its tax-deductible expenses during a given calendar year. Broadly speaking, expenses are only admitted as tax-deductible when, besides being effectively paid by the company, they are deemed necessary (to the business of the company), usual (as to their type), and normal (as to their amount).

Under the estimated profits taxation regime, a company's taxable profit is determined as a fixed percentage of its gross revenues, regardless of any deductible expenses the company may have incurred during the calendar year. Percentage rates are set by law in accordance with the type of business that generated a given part of the company's revenues.

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5 If the company has a considerable amount of tax-deductible expenses, it might want to be subject to IRPJ/CSL under the actual profits taxation regime, associated with the non-cumulative system for PIS/COFINS taxation. By contrast, if the company does not have substantial tax-deductible expenses, it would probably be better off being subject to the estimated profits taxation regime, in which case the cumulative system for PIS/COFINS taxation also applies.

Roughly speaking, under the actual profits taxation regime, the net profits (determined in accordance with the tax regulations) derived by SPEs focusing on the real estate market and arising from the sale of properties or leases are subject to IRPJ/CSL at a rate of 34 per cent, and to PIS/COFINS at a rate of 9.25 per cent. Expenses incurred with PIS/COFINS payments are also deductible from the IRPJ/CSL tax base, thus resulting in an effective tax rate of 30.855 per cent. Under the estimated profits taxation regime, revenues from property sales are subject to a tax burden of 6.73 per cent for IRPJ/CSL/PIS/COFINS.

6 More precisely, the IRPJ rate is 15 per cent plus a 10 per cent surcharge, where the 15 per cent rate is levied on all the tax base, whereas the 10 per cent surcharge is levied on the tax base in excess of 240,000 reais per annum.

For revenues arising from property lease (as well as those arising from assignment of rights *in rem*, for example, licensing of surface rights), the IRPJ/CSL tax base under the estimated profits taxation regime is both calculated as 32 per cent of the gross revenues derived by the company from that specific activity; for revenues arising from the sale of properties, the IRPJ/CSL tax base is set at 8 per cent and 12 per cent, respectively, of the gross revenues arising from these property sales. Once the tax base is finally determined, IRPJ/CSL is then assessed at a combined rate of 34 per cent.

Social contributions on gross revenues

Social contributions on gross revenues (PIS/COFINS) are two social contributions that are jointly levied on the gross revenues earned by Brazilian companies. These contributions may be levied under a cumulative or non-cumulative system.

Under the cumulative system, a flat combined rate of 3.65 per cent (0.65 per cent for PIS and 3 per cent for COFINS) will be levied over the gross revenues of the company, this taxation being final (i.e., with no authorisation for the Brazilian company to take PIS/COFINS tax-deductible credits associated with its inputs). In turn, under the non-cumulative system, PIS/COFINS are levied at a combined rate of 9.25 per cent (1.65 per cent for PIS, and 7.6 per cent for COFINS). In this case, however, companies are authorised to ascertain and deduct tax credits calculated on some of the inputs, as defined by law, used in their activities generating revenue that are also subject to PIS/COFINS, as well as on the depreciation of assets.

Companies that are subject to IRPJ/CSL taxation under the estimated profits taxation regime are subject to PIS/COFINS under the cumulative system at a flat and final 3.65 per cent combined rate. Conversely, companies subject to the IRPJ/CSL taxation under the actual profits taxation regime are subject to PIS/COFINS under the non-cumulative system at a 9.25 per cent rate.

Distribution of income

After-tax proceeds distributed by SPVs to foreign investors are exempt from withholding income tax (IRRF) (generally due on remittances at a 15 per cent rate), whereas remittances of interest on net equity are generally subject to IRRF at a rate of 15 per cent. Expenses related to such payments qualify as deductible from the IRPJ/CSL tax base if the SPV opts for the actual profits taxation regime.

FII taxation

Forex transactions for currency inflows or outflows related to FII investments are currently subject to IOF/FX at a zero rate.

Under the prevailing regulations, the income and gains recognised by the portfolio of investment funds in general are not subject to corporate taxation (IRPJ/CSL and PIS/COFINS) or to IRRF.

Therefore, as a general rule, positive results posted by investment fund portfolios have tax implications for investors only, at rates varying in accordance with their legal qualification and country of residency.

Nonetheless, apart from such general rule, specifically in respect to FIIs, Article 16-A of Law No. 8,668 of 1993 establishes that gains derived from variable and fixed income investment in general (except for securities related to the real estate market, such as CRIs) are subject to IRPJ/CSL on the fund portfolio under the same rules as those applicable to legal entities in general.

Further, Article 2 of Law No. 9,779/99 establishes that FIIs investing in a real estate undertaking whose developer, builder or partner holds, individually or together with a related person, more than 25 per cent of the fund shares are subject to same taxation rules applicable to legal entities in general.

Distribution of profits or gains

Article 10, sole paragraph of Law No. 8,668 of 1993 establishes that FIIs must distribute to their shareholders at least 95 per cent of profits recognised on a cash basis.

Under Article 17 of Law No. 8,668 of 1993, generally, the income and capital gains earned by the FII's local shareholders are subject to IRRF at rate of 20 per cent. This IRRF is treated as a definitive taxation for individuals or as an advance payment of IRPJ/CSL due on such income by legal entities in general. A different tax treatment applies to foreign investors.

Finally, the income earned by individuals from investments in FIIs is tax-exempt when:

a its shares are traded solely on a stock exchange or organised OTC securities market;
b it has at least 50 shareholders; and
c no shareholder holds 10 per cent or more of the FII shares, or is entitled to receive more than 10 per cent of the total income posted by the fund.

Distributions of income and gains earned from FIIs by foreign investors in general are subject to IRRF tax at a 15 per cent rate (except for investors located in tax havens). If those gains arise from the sale of FII shares on a stock exchange, they are tax-exempt (provided that investors are not located in a tax-haven jurisdiction).

FIP taxation

Forex transactions for inflow or outflow of funds related to investments in FIPs are subject to IOF/FX tax at the current rate of zero per cent.

Tax neutrality at FIP level

FIPs are flow-through entities under Brazilian tax law and, as such, no earnings or gains from transactions carried out by the fund itself are taxed at portfolio level. In fact, because the FIP is formed as a closed-end condominium (not as a standard legal entity), the FIP enjoys some tax benefits such as not being subject to any taxes on its own transactions (i.e., IRPJ/CSL and PIS/COFINS).

In practical terms, this means that if the FIP sells stock or other securities of its portfolio companies at a gain, the fund itself is not subject to any taxation in Brazil, and the same goes for distributions made to the FIP by its investees.

Broadly speaking, the effect of such transactions for the FIP is that its shares appreciate at the same proportion of earnings or gains then received; only when the FIP makes distributions on its shares to investors will Brazilian taxes be imposed (or not, as the case may be), as further explained below.

Taxation on distributions made by the FIP to its shareholders
The tax treatment accorded to profit distributions made by the FIP depends on the legal nature and the tax residence of the recipient investor. As a rule, distributions of proceeds from FIPs to local and foreign investors are subject to IRRF tax at a rate of 15 per cent.

Special tax regime for foreign investors
Under current tax rules, Brazilian FIPs may distribute proceeds to foreign shareholders without paying IRRF, provided that certain requirements are met. In that specific regard, it is worth commenting on the precise conditions under which this special tax treatment can apply.

Article 3 of Law No. 11,312/2006 establishes that:

> *IRRF is levied at a zero rate on income earned from investments made in FIPs when paid, credited, delivered or remitted to an individual or collective beneficiary that is resident or domiciled abroad and acts in the Brazilian financial markets pursuant to the rules and conditions prescribed by the National Monetary Council, which are generally accepted to be those rules and conditions set out in Resolution No. 4,373 of 2014.*

In addition, Article 3, paragraph 1 of Law No. 11,312 of 2006 sets out that:

> *The tax benefit referred to above:*
> *(i) is not granted to a shareholder that, individually or jointly with related parties, holds 40 per cent or more of the FIP shares, or when the FIP shares held by such shareholder, individually or jointly with related parties, assure him a right to receive more than 40 per cent of the total income earned by the FIP;*
> *(ii) is not granted to a FIP whose portfolio, at any time, contains debt securities or other fixed-income financial instruments worth more than 5 per cent of the FIP's net equity, excluding Brazilian treasury bonds or share convertibles;*
> *(iii) is not granted to those resident or domiciled in a country where income is either tax-exempt or taxed at a maximum rate of 20 per cent (tax havens).*

In short, to qualify for IRRF tax at a zero rate on FIP distributions, the non-resident investor must also: (1) be a '4,373 investor'; (2) hold less than 40 per cent of the fund, directly or indirectly; and (3) not be domiciled in blacklisted tax-haven jurisdictions.

If any of the aforesaid requirements is not met, the income distributed by the FIP to foreign investors is subject to IRRF tax at a rate of 15 per cent.

The IRRF tax at a zero rate applies as well when a foreign investor sells its FIP shares on the secondary market at a profit. Hence, if all requirements above have been duly met, the capital gains from sale of FIP shares by a qualifying non-resident investor should also qualify for IRRF taxation at a zero rate, as opposed to the general 15 per cent rate otherwise applicable to a non-qualifying investor.

vi Cross-border complications and solutions

Brazilian law distinguishes the real estate between urban and rural properties. As previously mentioned, no restrictions apply to foreign investments in urban properties.

Nonetheless, the current rules on foreign investment in rural properties in Brazil[7] impose some restrictions on the acquisition or lease of such properties by foreign individuals or entities, and also by Brazilian companies mostly held or controlled by foreigners. Such restrictions comprise, among others, the need for prior approval from the Brazilian Institute of Agrarian Settlement and Reform or from the National Congress, depending on the size of the rural property.

Such rules extend to corporate transactions resulting in direct or indirect transfer of rural properties, such as mergers and acquisitions, changes in corporate control, or if a Brazilian company becomes a foreign company. The acquisition or lease of rural properties by foreigners in contravention of the current rules may be voided.

Further, Brazilian law also regulates the occupancy of properties located within the country's border zone (a 150 kilometre-wide strip along the division line of the national territory). Prior consent from the National Defence Council is required for possession, ownership, rural lease or creation of any other security interest involving real properties located within the border zone. Such requirement is valid for foreign entities and for Brazilian entities held by foreigners (as majority or minority shareholders). The only exception is the tendering of guarantees *in rem* (i.e., mortgage and fiduciary lien) in favour of financial institutions with a foreign equity interest.

Currently, some alternative structures not covered by Law No. 5,079 of 1971 are being adopted by foreigners to sidestep current legal restrictions (see below).

V CORPORATE REAL ESTATE

As just mentioned, as a result of current restrictions on the acquisition and lease of rural properties by foreigners, some alternative structures are being adopted in the corporate real estate market. One structure currently used by foreign real estate investors is segregation of investments in the operating company (opco) and the real estate company (propco). In this structure, ownership of rural properties is held by the propco (the Brazilian company controlled by a local partner), whereas the opco is entrusted with operational activities. The propco and the opco execute one or more agreements by which possession and operation of the properties is transferred to the opco via contractual arrangements not restricted by Law No. 5,709 of 1971.

VI OUTLOOK

i Foreign investment in rural properties

A bill dealing with the restrictions on acquisition or lease of rural properties by foreigners is currently under discussion by the Brazilian House of Representatives. Such bill has a much more relaxed policy in which acquisition of rural lands by Brazilian companies would be free of restrictions, regardless of the controlling shareholders involved (except in case of control by foreign NGOs, foundations or sovereign funds). Such bill is yet to be further discussed and approved by the House of Representatives and the Senate, and then sanctioned by the Brazilian president. During such process, amendments could be made and the whole bill

7 Law No. 5,709 of 1971 and Law No. 8,629 of 1993.

could change (as has already happened in similar cases). Considering the current political scenario in Brazil, where alternatives to attract foreign investments are being discussed, it is likely that such restrictions will probably be reviewed and lifted by the end of 2018. Such scenario, however, stands little chance of review in the short term.

ii Disclosure

Another legal trend refers to compulsory identification of beneficial owners of foreign investment schemes for obtaining a CNPJ in Brazil, thus enabling the Brazilian authorities to identify the ultimate (direct or indirect) holders of equity interests in REOCs, SPEs, FIIs and FIPs. This requirement is difficult to implement when the foreign investment structure does not allow for identification of its beneficial owner.

iii Governance

The CVM is shortly to launch new rules lifting the bar on corporate government requirements for listed companies, and BM&FBOVESPA has recently announced that it will roll out in 2016 a package of reforms and adaptations to governance, compliance and disclosure rules applying to its special trading segments (Novo Mercado, Nível II, Nível I, and Bovespa Mais).

iv Activism and voting

Minority shareholders have increasingly voiced their opinions on shareholders meetings of Brazilian listed companies. New CVM rules are expected to address the possibility of distant and proxy voting, coupled with other mechanisms to spur active shareholder participation in decision-making.

Chapter 4

CANADA

Chris Murray and Jack Silverson[1]

I OVERVIEW OF THE MARKET

The Canadian real estate market has continued to produce superior total returns in the past decade.

Canada effectively avoided the global downturn at the end of the last decade, shielded by the then-strong commodity price rebound from the 2008–2009 global recession and a strong banking system that largely avoided excessive lending and overheated price inflation for real estate, particularly residential purchases, that occurred in the United States.

However, in the continuing historically low interest rate environment that has persisted since the 2008–2009 global crash, the Canadian real estate sector as a whole has experienced fairly significant price increases, with capitalisation rate compression across all real estate classes and most geographies.

Recently, the low Canadian dollar (reflecting the drop in demand for commodities starting in 2014) and Canada's reputation as a stable nation also served to attract significant offshore investment. That investment has further increased demand for Canadian real estate investments, particularly with residential real estate prices in Toronto and Vancouver accelerating at likely unsustainable rates of increase in 2015–2016 to the point of frequent news coverage and some political handwringing. The oil price turndown has, however, put some pressure on Alberta and Newfoundland property valuations in the same time frame.

Canadian domestic real estate investors can be broadly characterised as fitting within one of the three types of investors: (1) institutional investors, comprising primarily pension plans and life insurers; (2) public real estate entities, largely in the form of listed real estate investment trusts (REITs) with a smaller number of listed real estate operating corporations; (3) private entities, largely family-owned businesses, that develop or manage their own properties (or both), which are of greatly varying scale. Large-scale Canadian private equity

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investors are few in number and tend to manage funds that have a significant pension plan backing. However, very recently they have had a large role in several of the more prominent Canadian real estate transactions.

Canadian pension plans active in real estate consist of both the large globally recognisable public plans making direct investments, smaller public plans who tend to invest through funds and external managers, and some significant private corporate pensions who do both direct and indirect investing. Over the past three decades, Canadian pension plans commenced and increased an allocation of their assets to real estate. They are increasingly global in scope but still in the aggregate are much more heavily weighted to Canadian real estate than Canada's overall share of the global real estate market. A number of the very large plans that invest on behalf of various public sector employees significantly increased their allocation to real estate by privatising several of the largest public Canadian real estate companies in quick succession in 2000 and 2001.[2] The big 10 Canadian funds had over C$1 trillion in total assets as of 31 December 2014, of which an estimated C$140 billion is invested in real estate, with five of those funds being among the top 30 real estate investors globally.[3]

That has resulted, with continued investment through these entities and together with direct and indirect investment by other pension plans, in the large Canadian pension funds owning a very significant portion of both the Class A office space and the super-regional and premier urban shopping centre and office tower retail space in Canada's major metropolitan areas. Pension plans have assets in all real estate classes and also indirectly engage in some development activities. Pension plans generally can hold Canadian assets on a basis free from Canadian income tax under specific tax exemptions for Canadian registered pension plans.

A very significant portion of publicly listed real estate entities in Canada are in the form of REITs. However, the total market capitalisation of all TSX-listed REITs (of which there are 43) is approximately C$72 billion as of 30 June 2016, a fraction of that of REITs in the United States. There are only four REITs exceeding a C$5 billion market capitalisation.

First appearing as a public vehicle in the 1990s, a REIT is a trust that is a flow-through vehicle for Canadian income tax purposes, provided it meets certain criteria under the Income Tax Act (Canada) (ITA). Canadian REITs own a full range of real estate assets classes, including office, retail, industrial and multi-residential. REITs own a range of office investments although with one or two exceptions for Canada's largest REITs, they own only a few Class A office towers, and in the retail class are concentrated in regional and local shopping centres, controlling significant portions of the larger open format retail space. BPO Canada Inc (now Brookfield Canada Office Properties REIT) (Box) consolidated a number of Class A office properties owned in corporate form and then converted to a REIT structure in 2010.

There are comparatively fewer public real estate companies (13) in Canada, although there is one exceptionally large publicly listed limited partnership, Brookfield Properties Partners LP. It owns 83 per cent of Box and is global in its scope, with a market cap of C$22 billion. Typically, to be competitive with REITs in terms of cost of capital, a public corporation require large-scale and sufficient tax attributes to defer taxes over an extended

2 OMERS/Oxford; Teachers/Cadillac Fairview; Caisse de dépôt/Cambridge.

3 Boston Consulting Group 'Measuring the Impact of Canadian Pension Funds', October 2015, www.bcg.com/en-ca.

period. Corporations tend to be more active in the development side of the real estate business, especially in residential, due to both tax and fiscal constraints on REITs from undertaking too much development or other active income activities.

Private investors that are family-based tend not to be owners in the top-tier office or retail properties (unlike earlier decades in Canada), but do have significant industrial, retail and multi-residential holdings. Canadian-based private equity funds that are materially engaged in real property investing, other than the pension plans, which are a form of private equity investor, tend to be focused only on real estate investment and generally are not part of broader private equity 'conglomerates' that invest across all economic sectors. Canadian private equity funds, if funded by pension funds do compete in the office asset class, although more rarely in Class A offices, and are often engaged with real property assets that require active management and repositioning. One such entity, Kingsett Capital, has, however, recently been active in large-scale public deals.

II RECENT MARKET ACTIVITY

Large-scale property acquisitions and mergers driven by REITs and foreign investors (and are particular private equity firms) have been a characteristic of the market over the past several years with direct property purchases by smaller private equity funds whose limited partners are largely mid-size and smaller pension funds. Canadian corporate real estate entities have been developers rather than buyers for the most part. Brookfield affiliates have completed two major downtown Toronto projects and several of the pension funds have also built office towers in Toronto through their corporate real estate arms. But generally the large Canadian pension funds are now more globally focused than focused on Canada. The REITs have ridden a high demand for yield in a low interest rate environment, with their cost of capital at times allowing them to compete with pension plans even in the Class A office space. Witness the purchase of the Scotia Tower in downtown Toronto by a partnership of Dundee Office REIT and H&R REIT for C$1.27 billion in 2012. Most market observers expected ScotiaBank (the last bank to own its own headquarters) to sell to a pension fund or foreign investor. Interestingly, H&R in June 2016 exited Scotia Tower, roughly at cost, to a consortium led by private equity sponsor Kingsett Capital (through its funds) who partnered with AIMCO (the investment manager for the Province of Alberta pension and investment funds). They purchased a 50 per cent interest in Scotia Plaza (33.3 per cent from H&R and 16.7 per cent from Dundee Office REIT). While European investors have long had investments in Canada, their more prominent properties have been largely repatriated to Canadian hands over the past decade or so. However, Asian-based investment into Canadian real estate has surged in the 2014–2016 period.

i M&A transactions

There has been some consolidating merger activity in Canada between REITs in the last several years but overall less has occurred than some expected, as there have been few REITs trading significantly below net asset value. Mergers between REITs typically take place though a plan of arrangement, the steps of which conform to the provisions of Section 132.2 of the ITA allowing a tax deferred disposition of units, to ultimately receive units of another REIT as consideration.

The acquisition by Northern Properties REIT of True North REIT in 2015 created the third-largest publicly traded multi-residential REIT. Northern/True North shows the advantage of an agreed transaction in which, in part because of the tax deferred consideration structure available to the acquiring REIT, it is much more difficult for an entity other than a REIT to competitively intervene. Northern agreed to acquire True North for Northern REIT trust units while concurrently acquiring C$535 million of multi-residential assets from Starlight Investments (a party associated with True North) and a joint venture of Starlight and a subsidiary of the Public Service Pension Investment Board (pension plan) for cash and Northern units. True North had previously issued exchangeable LP units from an LP subsidiary on purchase of assets from its sponsor (an affiliate of Starlight). Northern issued exchangeable LP units of a Northern REIT subsidiary limited partnership for such True North LP units.

Northern offered 0.39 Northern REIT units per 1 True North unit (or a 16.4 per cent premium to the True North Unit closing price), which it paid to True North in exchange for the True North assets. True North then distributed those Northern units to its unit holders, all as prescribed under Section 132.2 of the ITA to allow the exchange on a tax-deferred basis. Northern financed the cash portion of the concurrent Starlight/PSPIB investment with a C$326 million secured bridge facility with its two advisee banks. Often the cash elements of merger consideration might be financed with a 'bought deal' in the capital markets, launched concurrently with or shortly after the merger announcement. The initial market reaction to the deal made this a less attractive proposition in this case. Northern units dipped in price on announcement but despite that, the transaction was strongly supported by Northern unit holders (87.8 per cent in favour of 71.8 per cent voted).

REIT-to-REIT mergers with other parties also occur although, as the REIT market is relatively small, there are typically only one or two such mergers a year. They are usually sector-consolidating transactions such as office REITs (Dundee REIT-WhiteRock REIT) or multi-residential REITs (CAP REIT and Residential Equities REIT) or, more recently in 2015, the C$2 billion merger of NorthWest Healthcare Properties REIT (NWH) with a related REIT, NorthWest Healthcare Properties International REIT (NWI). Both REITs were associated with same sponsor and manager and while in similar health-related realty spaces, NWI had assets outside of Canada and NWH assets were in Canada. It was also a unit-for-unit exchange on a tax-deferred basis designed to comply with Section 132.2 of the ITA with NHW as the surviving REIT. Such merger transactions under Section 132.2 are subject to land transfer tax on their Ontario and Quebec properties; so it made sense that the larger NWH (holding Canadian properties) was the acquirer of NWI (which held foreign properties).

ii Private equity transactions

When REIT trading prices dip significantly below their net asset value (NAV) or stay below NAV for an extended time they can become targets for acquisition. Private capital often plays a role in such transactions.

An example is the going-private transaction for TransGlobe REIT, a multi-residential REIT taken private by a consortium led by the original sponsor of TransGlobe, Daniel Driminer, through his Starlight Investments. Starlight manages its own capital as well as acting as sponsor of several private equity funds and several small public REITs. Starlight owned about 20 per cent of TransGlobe and offered with a consortium of its own funds, another private equity fund – TimberCreek Asset Management-and PSPIB, a large pension fund and a large REIT, to privatise TransGlobe in a complex multi-stage multiple series of purchases. CAP REIT agreed to buy 14 TransGlobe properties and TimberCreek 26, with PSPIB/Starlight JV acquiring 72 properties for cash and Starlight acquiring the residual REIT and its remaining 62 properties. The aggregate price was approximately C$1 billion, representing a 19 per cent premium to market. An interesting feature was a go-shop period without a match right that could inhibit prospective buyers, and with Starlight and PSPIB agreeing to tender to a superior bid if one was found. An alternative transaction did not emerge.

One of the largest real estate transactions in the past decade was the sale and split-up of Primaris Real Estate Trust, a holder of enclosed urban and regional shopping centres, was also private equity driven. It was precipitated by a hostile takeover bid led by Canada's most prominent real estate private equity investor, Kingsett Capital (acting through one of its funds), that partnered with one of the larger pension funds, Ontario Pension Board (OPB), and another large REIT, RioCan REIT. Kingsett offered C$4.4 billion cash or C$26 per unit (a 12.9 per cent premium) through a 'hostile' takeover bid supported by the OPB. RioCan agreed to buy one of the larger Primaris properties from the Kingsett consortium. Parties other than REITs cannot easily offer non-cash consideration to other REITs on a tax-deferred basis. Unlike in the United States, Canadian boards, whether REITs or corporations, have a very limited ability to prevent takeovers as Canadian securities regulators have historically struck down shareholder rights plans after 60 to 120 days. However, Primaris was successful in that time frame in attracting a white knight offer from a large (then primarily) office REIT, H&R REIT. H&R was able to offer its own REIT units on a largely tax-deferred basis, with a cash component of up to 25 per cent of the consideration that would be taxable to those electing cash (in whole or in part). The white knight offer was valued at C$4.6 billion or C$27.13 per unit (assuming full proration, a 16 per cent premium). In contrast with the hostile bid it was to be structured as a court-approved plan of arrangement subject to approval of Primaris unit holders. As H&R was to issue REIT units in excess of 25 per cent of its capital, H&R unit holder approval was also necessary under the TSX listing rules. A somewhat controversial break fee involving both cash and an option to purchase a key property (the one to be purchased by RioCan under the Kingsett offer) was agreed. Ultimately, no challenge to such fee was made as Primaris allowed Kingsett and its joint actors to partner with H&R in a further enhanced offer value at C$27.92 per unit (C$5 billion), involving both increased H&R units and increased cash (subject to dual proration, roughly 55 per cent cash and 45 per cent units). This was stated to represent a 22 per cent premium to the unaffected Primaris trading price prior to the original hostile bid. It too was structured as a plan of arrangement using Section 132.2 of the ITA with Kingsett, RioCan and OPB purchasing 18 shopping centres from Primaris for cash (used to redeem Primaris units from the holders electing cash) and then H&R exchanging its REIT units for the remaining assets of Primaris (25 properties and the platform), with Primaris then distributing those H&R units to its unit holders on a tax-deferred basis. As a result Primaris unit holders received both increased cash and H&R units representing about 16 per cent of H&R.

While in the previous decade there were a number of acquisitions by US health or seniors care REITs acquiring Canadian senior REITs, Ventas/Sunrise REIT, Welltower/HealthLease, over the past two years Asian private investors and insurers, (primarily out of mainland China and Hong Kong) have been paying what some market commentators regard as record-setting CAP rates for the direct purchase of office buildings in Toronto and Vancouver. Anbang Insurance based in China purchased (1) the four-office tower Bentall complex in Vancouver from a Canadian pension fund and a Canadian insurance company, reputedly for over C$1 billion dollars; and (2) a land lease on a secondary downtown Toronto office building reported at C$110 million. Asian investors have also been buying Canadian hotels, including BlueSky a newly incorporated Hong Kong company (also reported to be associated with Anbang) recently purchased InnVest REIT, the largest Canadian hotel REIT

(109 properties) for C$7.25 per unit (a 33 per cent premium – high for REIT transactions) or C$2.1 billion (including assumed debt). The transaction included a C$100 million deposit (unusual for a public deal) and a C$32 million reverse break fee.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

There are approximately 56 publicly listed real estate entities in Canada, of which approximately 40 or so are REITS (as defined in the ITA) and a dozen are corporations. There are also a few non-REIT trusts that have a significant real estate component that are often referred to as REITs but, because of their active business activities (senior homes or hotels), may not be technically qualified as REITs (as defined under the ITA). These are taxed under the 'specified income fund trust' or SIFT tax regime, which is not a flow-through regime, and thus not as favourable as the REIT tax regime.

There are also a number of very large private real property corporations owned by pension funds and also by families[4] that are very active developers of office towers, condominiums and malls in particular. There has been massive condominium development across Canada, especially in Toronto and Vancouver driven mainly by private capital in the past decade.

REITs

As noted above, many of the listed real estate structures are in the form of a REIT. A REIT is governed by the terms of its trust deed as a matter of the law of the province in which it is formed. There is no statutory framework for trusts similar to corporate statutes, although securities laws apply to publicly traded REITs. Investors can purchase units of the trust as they would purchase shares of a corporation and legislation has extended limited liability protection to investors. Most REITs do not have some of the rights and remedies provided to shareholders in corporations such as the oppression remedy, dissent rights and rights to call meetings or make proposals. Pressure is mounting from some institutional governance groups for REITs to adopt more uniform trust deeds and rights fully parallel to those available to corporate shareholders, and an increasing number of REITs are adopting some of those rights.

REITs are designed to be a 'flow-through entity' investment, meaning that the trust meeting the ITA REIT qualifications pays no Canadian income tax provided that the REIT distributes its annual taxable income to its unit holders. In the case of REIT units held by a non-resident, distributions of income to the non-resident unit holder by the REIT are generally subject to withholding tax at a rate of 25 per cent (subject to reduction by tax treaty); however, the gain realised on a disposition of REIT units is generally not subject to Canadian tax provided that the unit holder and those persons not dealing at arm's length with the unit holder hold less than 25 per cent of the units of the REIT.

Typically rather than owning a beneficial investment in property directly, (although a REIT can do so), there will be a limited partnership or multiple LPs below the REIT that

4 Examples are Orlando Corp. (the Fidari family), Tridel Corporation (condominium developer), Great Gulf Homes (residential and condominium) and Triple Five Group owned by the Ghermezians (West Edmonton Mall and the Mall of America).

own the properties. Among other things, an LP can issue LP units to the persons from whom a REIT desire to purchase property on a tax-deferred basis, whereas REITs cannot issue REIT units to property sellers on such basis. Such LP units are typically exchangeable into REIT units on a taxable basis and often are associated with special voting units that provide such LP unit holder with a vote in the REIT as if they held an equal number of REIT units.

The criteria for REIT status under the ITA has been altered several times, the last time being in 2012. Essentially, to qualify as a REIT, the trust must limit its activities primarily to owning real estate as capital property, and receiving passive rental and interest income, with limited baskets for non-capital real property, other non-cash assets and income from business activities such as third-party management or development. REITs typically cannot own real estate-based operating businesses such as seniors facilities or hotels. To the extent that a trust not qualifying as a REIT for ITA purposes has sufficient non-cash deductions such as capital cost allowance on its buildings, it may be able to reduce its current taxable income substantially in the short run and make tax-deferred distributions to its Canadian resident unit holders to achieve a similar outcome to REIT treatment. REITs also have foreign ownership restrictions, as REITs must also qualify as 'mutual fund trusts' under the ITA so that they cannot be operated primarily for the benefit of non-residents. As a practical matter, this typically translates into a 49 per cent foreign ownership limit in REIT constating documents.

The management of a REIT can be conducted internally through its own employees or externally provided by a manager under contract. While sponsors typically prefer external arrangement, the 'market' tends to favour internalised arrangement.

Most Canadian REIT's are the product of smaller IPOs (typically under C$300 million). However, a few were created by conversion of existing corporations or spinout from existing corporate entities. The only Class A Office REIT is Brookfield Canadian Office Properties REIT, which was formed in 2010 by the conversion of the BPO Properties Inc into a REIT as part of the ongoing consolidation of Brookfield's Canadian real estate properties into one entity. The REIT is 83.7 per cent owned by Brookfield Property Partners LP, itself a spin-off of Brookfield Asset Management's property division into a flow-through limited partnership based in Bermuda which is by far the largest publicly listed property entity in Canada.

Corporate spin-outs by REIT IPO

Two of the largest real estate IPOs in the past five years were REIT IPO spin-outs of the real property assets of two of Canada's largest domestic retailers. There is no easy tax-efficient manner in which to distribute assets to stockholders under the ITA so such spin-outs in Canada have happened by initial public offering. The first, Choice REIT, was created to hold one local shopping centre owned and anchored by Loblaw grocery stores. The second, CT REIT, was created to buy a portion of Canadian Tire's anchored local shopping centres. In each case the sponsor selling retailer was itself a listed public entity and the IPO served to fund the cash portion of the purchase price of the property transferred by the parent to the new REIT. Unlike the BPO Properties REIT conversion, where the Brookfield's tenant base is exceptionally diverse, in these two retail spin-outs there was essentially one tenant occupying over 90 per cent of the leasable space. In those two instances, the fact that the sponsor of the IPO (and principal REIT tenants) Loblaw and Canadian Tire were investment grade rated was a key part of the ability of the underwriters to achieve the pricing that the sponsors desired. The sellers retain a large majority interest in the REITs in the form of tax-deferred exchangeable limited partnership units and REIT special voting units, with cash, notes or preferred securities being paid up to each sellers' up their tax cost base in the assets they sold to their REITs. In each case, various arrangements exist around the sale to the REITs of a future pipeline of properties retained by, or to be developed by, the sellers, as well as sponsor or seller governance rights. The Choice REIT IPO raised C$460 million, while the CT REIT raised C$303 million from the public with the sponsors retaining an initial interest of just over 80 per cent of the REITs in each case.

Typical Canadian REIT IPOs are generally much smaller than those in the United States and, interestingly, as a result have attracted a number of US-based cross-border REITs (also known as 'foreign asset income trusts' or 'FAITs' – Canadian-formed REITs owning foreign assets) that are likely too small to be sold in the US capital market. These are typically REITs in Canada and, in some instances, are also qualified as REITs under US law.

ii Real estate PE firms – footprint and structure

The dominant private equity real estate players in Canada are Canadian pension plans with specialist real estate divisions. Many of the largest have at their core properties obtained, and personnel gained, from taking private the largest public real estate operating companies. The top 10 plans have some C$140 billion dedicated to real estate in Canada and abroad (as of December 2014). There are also privately controlled private equity sponsors with the best known and likely the largest being Kingsett Capital. It regularly transacts in billion dollar-plus transactions in both the publicly traded REIT market and direct private transactions involving high-profile real property. Unlike Kingsett (the largest specialist real estate private equity investor) and the large pension funds, which operate both the public markets and in private direct real estate, most Canadian real estate private equity funds operate in the private real estate market with direct acquisitions of real property. There are fewer such private equity funds in Canada compared to the United States and the equity raised for most individual funds tends to be in the hundreds of millions, and not billions.

Almost all privately sponsored private equity pools (as opposed to private pension fund-owned real estate corporations) are held in the form of limited partnership; as a limited partnership wholly owned by Canadian residents is a flow-through entity for income tax purposes. The typical limited partnership has a general partner owned by the sponsor and a limited number of limited partners, typically pension plans but occasionally high net-worth entities.

There has been a limited amount of activism in the REIT space but what exists has largely been driven by private equity. In fact one entity, Orange Capital (now in wind down), was behind both of the campaigns in the space. One such foray in 2014 resulted in Orange, together with Kingsett Capital (an existing holder), gaining representation on the board of InnVest REIT together with internalisation of management that had previously rested externally with sponsor and another shareholder of the REIT, Westmont Hospitality. While the new board undertook a series of refinancing and acquisitions and dispositions, the trading price of InnVest did not move marketly until the BlueSky acquisition of InnVest in June 2016 at a large premium to market. Orange also successfully challenged a transaction involving Partners REIT where a large acquisition, allegedly involving an undisclosed insider, was reversed. As part of its campaign, Orange, which was not then a unit holder, launched an innovative mini-tender for Partners REIT at a small premium to market. As it was only for only 10 per cent of the units, the offer was not subject to the takeover bid rules. Orange sought a proxy from all tendering shareholders in respect to any and all REIT units deposited, that it sought to vote at the Partners REIT AGM in favour of a competing slate of Orange nominees. The proxy was stated to be effective whether or not Orange actually took up under the offer or prorated the tendering unit holders. Partners REIT complained to the Ontario Securities Commission (OSC) that, among other things, the offer was so conditional it was an option. As a result, among other things, Orange agreed that if 10 per cent of the shares were tendered, it would be obligated to take up under the offer, allowing withdrawal of tenders. Strangely, the OSC staff did not strike the proxy provisions as part of the settlement with Orange, so that Orange would have been permitted to potentially vote a massive number of Partners REIT units without any ownership thereof. Interestingly, Partners nominated new independent directors and the Orange offer did not reach its 10 per cent threshold and was terminated. Orange did effectively cause Partners REIT to put forward new directors and to reverse the disputed transaction.

IV TRANSACTIONS

i Legal frameworks and deal structures

While several different methods exist to acquire control of a Canadian public company, M&A transactions in Canada are most commonly effected by a 'plan of arrangement' and less frequently by a 'takeover bid'. These transaction structures, which are not unique to public real estate M&A, are outlined below.

Plan of arrangement

A statutory arrangement, commonly referred to as a plan of arrangement, is a voting transaction governed by the corporate laws of the target company's jurisdiction of incorporation. It is first negotiated with the target board of directors and remains subject to the approval of the target security holders at a special meeting held to vote on the proposed transaction. Notably, an arrangement also requires court approval. Due to the ability to effect the acquisition of all of the outstanding securities of a target in a single step and its substantial structuring flexibility, the majority of board-supported transactions are structured as arrangements.

In the REIT-to-REIT merger context the use of a plan of arrangement necessitates the presence of a corporate entity somewhere in the structure, such as a corporate general partner of an LP subsidiary. Courts have to date been quite accommodating in the use of the plan of arrangement structure, even where the transaction is primarily a REIT-to-REIT merger transaction.

The target entity applies to court to begin the process of effecting the arrangement. An initial appearance will be made before the court for an interim order setting the procedural ground rules for the arrangement, which is almost always uncontested. The interim order will specify, *inter alia*:

a the manner in which a special meeting of the security holders will be called and held (e.g., form of proxy solicitation materials and disclosure documents to be sent to security holders, record date for establishing security holders entitled to vote on the transaction, applicable notice periods, time and place of meeting);
b the persons entitled to vote at the meeting;
c whether any class of persons will be entitled to a separate class vote; and
d the requisite approval thresholds required to approve the arrangement.

Securities legislation sets out required disclosure and disclosure standards.

Once the meeting of the security holders is held and the arrangement resolution has been approved by the requisite majorities of security holders, the target seeks a final court order approving the arrangement. The final order will be granted if the court is satisfied that the arrangement is 'fair and reasonable'. While disaffected stakeholders can appear at the final order hearing to challenge the arrangement, the vast majority of arrangements are approved without opposition.

Although the shareholder approval threshold for an arrangement is generally subject to the discretion of the court and addressed at the procedural hearing when the interim order is sought and obtained, an acquirer will typically propose that it seek the same approval threshold as would be required under the applicable corporate law statute governing the target company involved in the transaction if the arrangement steps were effected outside the arrangement process. In most Canadian jurisdictions this threshold is 66⅔ per cent of the votes cast at the meeting of the target security holders. The approval of a majority of the minority shares voted at the meeting may also be required in circumstances where the business combination rules under securities law apply to the transaction. Other convertible securities such as warrants and convertible debentures are typically not given the right to vote in an arrangement unless their rights under the applicable indentures or contracts are being altered as part of the arrangement in a manner that is not fair and reasonable.

A unique feature of REIT-to-REIT mergers is that in order to achieve tax deferral, if offering REIT units for consideration the steps within the transaction must take place in a manner required under Section 132.2 of the ITA, and that requires a plan of arrangement.

Takeover bid

A takeover bid is a transaction by which the acquirer makes an offer directly to the target company's security holders to acquire their securities. A takeover bid is the substantive equivalent of a tender offer under US securities laws. Although the board of directors of the target company or trustees of a REIT have a duty to consider the offer and an obligation to make a recommendation to security holders as to the adequacy of the offer, the takeover bid is ultimately accepted (or rejected) by the security holders. As the support of the target directors is not legally required, a takeover bid is the only practical means to effect an unsolicited or hostile acquisition. Takeover bids are also used infrequently for friendly transactions in Canada. However, as most transactions between REITs involve equity consideration and there is no tax deferral for a direct exchange of REIT units for REIT units, hostile takeovers are comparatively rare in the REIT space.

Legislation and governing principles

Takeover bids are regulated under a uniform regime adopted by each Canadian province and territory.

A takeover bid must be made to all registered holders of the class of voting or equity securities being purchased (and sent to all registered holders of securities convertible into or exercisable for such voting or equity securities). The same price per security must be offered to each holder of the class of securities subject to the bid.

There are also minimum standards relating to the conduct of the bid, including disclosure requirements, the timing and delivery of takeover bid materials, and rules designed to ensure the equal treatment of all security holders.

A formal takeover bid is made pursuant to a disclosure document commonly referred to as a takeover bid circular. This document must contain prescribed information about the offer, the offeror and the target company. When the offered consideration consists (in whole or in part) of securities of the offeror, the circular must also include prospectus-level disclosure about the offeror. It is generally not necessary to pre-clear the contents of a takeover bid circular with the securities regulators in Canada and the takeover bid circular is not generally subject to their review once it is filed, absent a complaint being made.

Effective since 9 May 2016, fundamental changes were recently made to the Canadian takeover bid regime. The new provisions increase the amount of time afforded to a target issuer to respond to a hostile bid, effectively resulting in a 105-day 'permitted bid' regime. The regime will have important implications for both tactical and strategic rights plans, and may also influence how transactions are structured in the future.

Under the new takeover bid regime, all non-exempt takeover bids (including partial bids) are subject to the following requirements:

a takeover bids are subject to a mandatory, non-waivable minimum tender requirement of more than 50 per cent of the outstanding securities of the class that are subject to the bid, excluding those beneficially owned, or over which control or direction is exercised, by the bidder and its joint actors (the minimum tender requirement).

b following the satisfaction of the minimum tender requirement and the satisfaction or waiver of all other terms and conditions, takeover bids will be required to be extended for at least an additional 10-day period (the 10-day extension requirement).

c takeover bids will be required to remain open for a minimum of 105 days, unless the target agrees to a lesser period for the bid or another transaction.

When does a takeover bid occur?

Determining whether a takeover bid exists is based on objective factors and, in particular, on the percentage of voting or equity securities beneficially owned or controlled by the offeror (and any joint actors) plus the number of additional securities subject to the takeover bid (as opposed to the more subjective factors used in the United States, such as the method and timing of acquisition). The takeover bid threshold is 20 per cent of any class of voting or equity securities. In determining whether the threshold level of ownership by the offeror will be crossed, the number of securities beneficially owned by the offeror includes securities that the offeror has a right or obligation to acquire within 60 days (e.g., through options, warrants or convertible securities) and securities held by affiliated entities and joint actors.

Advantages and disadvantages of arrangement and takeover bid structures

An arrangement is usually the preferred transaction structure for friendly transactions due in part to the ability to effect the acquisition of all outstanding securities of a target company in a single step and in part to its substantial structuring flexibility. In particular, arrangements are not circumscribed by the takeover bid rules (e.g., there are no prohibitions against financing conditions, collateral benefits or paying differential consideration to shareholders) and, importantly, can facilitate tax planning objectives by enabling an acquirer (and a target) to set out the precise series of steps that must occur at and following the effective time of an arrangement.

Where there are lengthy regulatory approvals, the 'fiduciary out' ends on the date of the shareholders' meeting, whereas in a takeover bid the fiduciary out effectively ends on the date all bid conditions have been satisfied or waived.

Unless the target is a US registrant, there is no SEC review of the proxy circular for an arrangement in certain circumstances where a takeover bid circular to acquire the same securities would be subject to SEC review. Further, there is the potential availability of registration exemption under US securities laws in securities exchange arrangement.

In addition to the flexibility of an arrangement for implementing complex transactions, the directors of the target company may take comfort from the fact that an arrangement has been court-approved and determined to be fair and reasonable, potentially insulating the transaction and directors of the target from criticism or post-closing liability.

ii Directors' duties

The corporate statutes in Canada impose two principal duties on directors: the fiduciary duty and the duty of care. Directors cannot contract out of these responsibilities and may be held personally liable for any breach of these duties. REITs are trusts and although there is not a direct equivalent standard by statute, the common law applies at least a similar standard to that of corporations (and in theory a higher one). REITs in their trust deeds have generally adopted the corporate standards applicable to directors. Although not yet subject to an express definitive decision, Canadian courts have typically treated trustees of public REITs by the standards applied to directors of public companies.

Fiduciary duty

Directors and trustees are fiduciaries of the entities they serve.

The Supreme Court of Canada set out the scope of the fiduciary duty in the corporate context in its decision in *BCE Inc*.[5] The key principles from the decision are as follows:

a the fiduciary duty is owed to the corporation, not to any particular stakeholder;

b the fiduciary duty of the directors is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is a going concern, it looks to the long-term interests of the corporation. The content of this duty varies with the situation at hand;

c in considering what is in the best interests of the corporation, directors may look to the interests of, among others, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions;

d the duty of the directors to act in the best interests of the corporation comprehends a duty to treat individual stakeholders affected by corporate actions fairly and equitably based on those stakeholders' objectively determined reasonable expectations; and

e where stakeholders' interests conflict, there is no principle that one set of interests should prevail over another set of interests. In particular, unlike the *Revlon* duties under Delaware law, there is no principle that shareholder interests in maximising shareholder value prevail over other stakeholder interests in a change of control transaction. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised their business judgement in a responsible way and resolved any conflicting interests fairly and equitably based on an objective determination of such stakeholders' reasonable expectations.

Although the court in *BCE* did not specifically endorse a duty to maximise security holder value, equity security holders obviously have a great deal at stake in a change of control transaction, and have a reasonable expectation that directors will give considerable weight

5 *BCE Inc v. 1976 Debentureholders* [2008] 3 SCR 560, 2008 SCC 69.

to their interests when considering how to respond to an acquisition proposal. Accordingly, determining whether an acquisition proposal delivers the best value reasonably available to equity security holders should remain a central focus of directors' and trustees' deliberations.

Duty of care

In discharging their duties, directors must also 'exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances'. This standard of care can be achieved by any director who devotes reasonable time and attention to the affairs of the corporation and exercises informed business judgment. The standard of care is measured against the objective standard of what a reasonably prudent person would do in comparable circumstances. Failure to meet the standard often stems from passivity and a failure to inquire.

In *BCE*, the Supreme Court of Canada confirmed the existence of a Canadian 'business judgement rule' under which courts will defer to directors' business decisions as long as they are within a range of reasonable alternatives. Courts defer to decisions of directors taken in good faith in the absence of conflicts of interest, provided the directors undertook reasonable investigation and consideration of the alternatives and acted fairly. Courts will not subject directors' business judgement to microscopic examination and will not substitute their view for that of the directors, even if subsequent developments show that the directors did not make the best decision.

In discharging the duty of care, a threshold consideration is whether a board should constitute a special committee of independent directors or trustees to review and consider a takeover bid or credible acquisition proposal.

Where there is a true conflict transaction that engages the procedural protections contained in MI61-101[6] (e.g., because the potential acquiring party is a related party of the target company), then a special committee of independent directors with independent legal and financial advisers should be, and may be required to be, established to review an acquisition proposal, supervise and direct any negotiations, and make recommendations to the board.

In other circumstances where the conflict is not as acute, such as where there is a perception that management may be influenced by considerations relating to their continued employment, the board will need to consider how best to address the conflict. In some cases, the conflict may be addressed by excluding management and any potentially conflicted director from those portions of the board's deliberations as considered appropriate in the particular circumstances.

In other cases, the board may choose to establish a special committee. Canadian courts have looked favourably upon the establishment of special committees as a means of addressing potential conflicts. A special committee may also be desirable as a matter of convenience, depending on the relative expertise of the directors and their differing time commitments and availability.

6 Multilateral Instrument 61-101 – Protection of Minority Security Holders in Special Transactions, Ontario Securities Commission.

iii Acquisition agreement terms

As noted most public real estate merger transactions take place under a plan of arrangement. The acquirer and target will enter an arrangement or a merger agreement with all of the typical terms found in any merger agreement.

Common deal protections in supported public transactions, real estate or non-real estate, include non-solicitation ('no shop') provisions, in which the target company agrees not to solicit or negotiate other offers, as well as a commitment to recommend the supported transaction and pay a break fee if the agreement is terminated in certain circumstances. The non-solicitation provisions generally permit the board in the exercise of its fiduciary duties to engage with a rival bidder that makes an unsolicited acquisition proposal that is likely to result in a superior proposal. The fiduciary out of the board of directors also typically permits the board to change its recommendation and enter into an agreement to support a superior proposal. What constitutes a superior proposal is a matter of negotiation, but it is almost invariably defined to include a requirement that the acquisition proposal is more favourable from a financial point of view to the target security holders than the existing transaction. A break fee is permissible under Canadian law, provided that it represents a reasonable commercial balance between its negative effect as an auction inhibitor and its potential positive effect as an auction stimulator (including if the fee was necessary in order to induce a bid). Break fees typically range from 2 to 4 per cent of deal equity value.

In defending against hostile bids, target boards have also employed a number of defensive tactics. The most common is the use of rights plans or poison pills, although under the new rules these will be void after 105 days. Additional defensive tactics include issuances of treasury securities to dilute the bidder or potential bidder (often by placing the securities in friendly hands), the sale of assets, recapitalisations and asset lock-ups.

The main difference in a real estate merger context is the specific step mechanics of the plan of arrangement itself must conform with the edicts of Section 132.2 of the ITA to ensure a tax deferred rollover for any unit to consideration offered by the buying REIT. A full cash deal is typically no different to any merger transaction. It would be typical to enter such agreements only after all diligence was conducted as in any public transaction. Conditions in public real estate mergers are typically similar to any public merger transaction, although there might be a condition addressing the necessary percentage level of mortgagee consents to the assumption of mortgages that is not typically present in non-real estate public deals.

iv Hostile transactions

Hostile transactions do take place in Canada but they are very rare, and even rarer among REIT-to-REIT transactions as a tax-deferred unit consolidation transaction is only available through a plan of arrangement conforming to the requirements of Section 132.2 of the ITA. A plan generally requires target board cooperation. As a result, almost all REIT-to-REIT transactions that occur are by plan of arrangement. Even the rare one involving cash for units that starts as a hostile transaction generally ends up in an agreed plan of arrangement.

v Financing considerations

Public REIT-to-REIT mergers are typically unit-for-unit transactions with assumption of the underlying mortgages of the target REIT. The cash portion of a transaction not sourced from funds to hand might be bridge financed through a bank facility to be subsequently repaid through public debenture or equity issue.

However, the Canadian bought deal underwriting structure, whereby underwriters guarantee their underwriting, offers certainty of funding to public REIT acquirers who, as a result, will often arrange bought deal financing concurrently with the merger transaction announcement. Such bought deals can be through a subscription receipt structure, which allows the financing to be contingent on the closing of the merger.

Private equity acquirers will draw down of equity commitments of their LPs or pension funds will draw on their vast reserves of liquid securities to fund the equity portion of transactions and assume underlying mortgages. Credit lines or fresh mortgage alternatives must be available to refinance mortgages that have provisions requiring repurchase upon change of control (which is common), but most mortgagors tend to consent to the assumption of their mortgages, especially if the buyer is a significant player in the real estate market.

vi Tax considerations

ITA

Income tax

Canada's tax regime is primarily governed by the federal ITA, as well as sales tax, corporate tax and other tax laws of the provinces and territories. The ITA imposes income tax for each taxation year on the taxable worldwide income of every 'person' resident in Canada in that taxation year, which includes corporations. Corporations, trusts and individuals are persons for this purpose (although a trust is not a legal entity). At common law, a corporation will generally be resident in Canada if its 'central management and control' is located in Canada. Further, under the ITA, corporations, if incorporated under Canadian federal, provincial or territorial law, are deemed to be resident for this purpose. Provincial corporate income tax regimes generally follow the ITA rules.

The ITA also imposes taxes on non-resident persons who carry on business in Canada. There are also withholding taxes on certain types of passive income, including rent, interest and dividends. In addition, the disposition of 'taxable Canadian property' (as defined in the ITA) may result in a non-resident being subject to tax in Canada. Therefore, the tax treatment of an investment made by a non-resident in Canadian real estate will depend upon whether the investor makes the investment directly or through a Canadian entity, such as a corporation. If the investment is made directly by the foreign investor, the tax treatment will vary based on whether the Canadian real estate generates business income or property income.

As of 30 July 2016, the basic Canadian combined federal and provincial tax rate for general income earned by corporations ranges from 26 per cent (British Columbia) to 31 per cent (Nova Scotia) with Ontario at 26.5 per cent and Alberta at 27 per cent. The basic Canadian combined federal and provincial tax rate for incomes earned by individuals including trusts range from 44.5 per cent (Nunavut) to 58.75 per cent (New Brunswick) with Ontario at 53.53 per cent and Alberta at 48 per cent.

Tax treaties

Canada is a party to approximately 90 income tax treaties with other jurisdictions. These tax treaties often reduce the withholding tax rate imposed under the ITA and the branch tax rate described below.

Indirect investment through a Canadian corporation

Tax on business profits and deduction of interest

If a non-resident invests through a Canadian corporation, the corporation will be subject to tax on its business profits as determined in accordance with ordinary commercial principles. For this purpose (subject to the thin capitalisation rules discussed below), interest expense is generally deductible if: (1) it is reasonable in amount; (2) it is incurred pursuant to a legal obligation to pay interest on borrowed money or unpaid purchase price; and (3) the underlying debt is used for the purpose of earning income from business or property. In lieu of book depreciation, the ITA sets out a capital cost allowance that provides taxpayers with deductions that they may take on a discretionary basis.

Thin capitalisation rules

The thin capitalisation rules disallow the deduction of interest payable by a Canadian corporation on debts owing to 'specified non-resident persons' (being various non-arm's length parties) to the extent that the ratio of such debts to the corporation's equity exceeds a ratio of 1.5:1.

Withholding tax

Subject to treaty relief that may reduce or eliminate withholding tax, a Canadian subsidiary must withhold tax at a rate of 25 per cent on several types of payments to non-residents, including dividends, interest paid to non-arm's-length parties, participating interest, certain management or from administration fees, rents and royalties. Treaties provide extensive relief for dividends, often as low as 5 per cent (if the recipient holds over 10 per cent of the voting shares of the issuer) or otherwise at a 15 per cent rate.

Most interest payments and commitment fees payable under a traditional loan from a foreign arms-length lender are now exempt from withholding tax. However, loans with participating interest and loans between non-arm's-length parties are still subject to withholding taxes in Canada, although again treaties can reduce the rates on non-arm's-length interest to as low as 0 per cent in the United States and to 10 per cent to 15 per cent, in most other treaty jurisdictions.

Carrying on business directly in Canada

Tax on business profits

If a non-resident invests directly in Canadian real estate and such investment constitutes the carrying on of a business,[7] the non-resident will be required to file a Canadian tax return and will be subject to tax based upon the non-resident's taxable income earned in Canada.

Taxable income earned in Canada is generally calculated on the non-resident's business profits from its operations in Canada and based on rules similar to those set out above with respect to Canadian corporations; however, the thin capitalisation rules applicable to Canadian corporations would not apply.

7 Such as developing property for resale or investing in a hotel, assisted-living facility or any rental property where the level of service goes beyond that typically associated with a rental property (for instance, the cleaning of individual suites).

Withholding tax and branch tax
A non-resident is required to remit withholding tax in respect of payments made to other non-residents if such payments are deductible in computing its taxable income earned in Canada. Examples include participating interest or interest paid to non-arm's-length parties. In addition, if the non-resident is a corporation, it may be subject to branch tax, which is designed to approximate the withholding tax that would have been owed on dividends if paid by a Canadian subsidiary. If the non-resident is not a corporation, it generally will not be subject to branch tax; however, it will be required to pay tax on its business profits at individual tax rates, which are typically higher than corporate tax rates.

Earning property income directly from Canada
If a non-resident investor earns income from property (for example, rental income where the investor did not provide a level of service beyond that normally associated with a rental property), the gross amount of rental income will be subject to a 25 per cent withholding tax (subject to reduction by tax treaty). Non-residents have the option, however, to elect to file a Canadian tax return and pay tax based on the profits from the Canadian rental property. Such tax would be calculated in a manner similar to that described above in 'Carrying on business directly in Canada'.

Gain on disposition of investment
Canadian real estate and shares of corporations that primarily derive their value from Canadian real estate, except for certain shares of public corporations, are taxable Canadian property such that tax is payable under the ITA on the disposition of such property. In the case of property held for resale or as an adventure in the nature of trade, the full amount of the gain is subject to tax at normal rates under the ITA.

Where an investor directly holds land and buildings that are not held for resale or as an adventure in the nature of trade, the gain on the sale of the land is generally taxed as a capital gain such that only 50 per cent of the gain is included as income. On a sale of a building, the amount of capital cost allowance previously claimed by the seller is included in the seller's income to the extent that the sale proceeds are greater than the undepreciated capital cost of the building and less than the original cost of the building. To the extent that the sale price exceeds the original cost of the building, only 50 per cent of the gain is included in income. On a sale of shares, a gain is typically treated as a capital gain such that only 50 per cent of the gain is included in income unless the shares were held for resale or as an adventure in the nature of trade.

Typically, a purchaser will not buy taxable Canadian property from a non-resident until the non-resident obtains a certificate from the Canada Revenue Agency certifying that all relevant taxes have been paid or that the seller has furnished security for such taxes. If the purchaser is not provided with such a certificate, it would be liable for tax equal to 25 per cent of the purchase price in the case of land or shares held as capital property, and 50 per cent in the case of buildings or property held for resale or as an adventure in the nature of trade. Under these circumstances, the purchaser is entitled to withhold from the purchase price and pay to the Canada Revenue Agency the amount required to satisfy the tax liability of the purchaser under the ITA.

Transfer taxes assessed upon disposition of real estate

Provincial land transfer tax

In Canada, real estate transfer also triggers land transfer tax that the purchaser must pay when a real estate transaction closes. The tax is a provincial tax and the rate varies depending on the province (and there can be additional municipal surtaxes). The transfer tax is stratified depending on the total value of consideration paid, which normally includes the cash paid for the land, in addition to the debt assumed and all other benefits transferred to the seller. The tax is payable on the fair market value of the real property and there is a general anti-avoidance regime. Exemptions from land transfer tax are also available; for instance, certain inter-corporate transfers between affiliated corporations are exempt provided the transfer is not registered. Ontario, which has the highest rate of such tax, also recently revoked an exemption that was available to purchasers of certain partnership interests.

Municipal land transfer tax

Pursuant to municipal by-laws, the cities of Montreal and Toronto have implemented municipal land transfer surtaxes to be paid by a purchaser in addition to the provincial land transfer taxes discussed above. The municipal land transfer tax applies to all purchases of real property within the city limits and is charged on a graduated basis depending on the value of consideration paid for the property. British Columbia has recently instituted a 15 per cent surcharge on foreign buyers of residential real estate in Vancouver.

Value added tax

Goods and services tax

A purchaser of real estate in Canada may be required to pay goods and services tax (GST) or harmonised sales tax (HST) (described below), subject to certain exceptions. In the provinces and territories where GST is levied, the rate is 5 per cent. Sales of used residential housing and certain sales of farmland are generally exempt from GST. Further, a purchaser is generally not required to pay GST if registered for GST purposes under the Excise Tax Act (Canada) and the purchaser intends to use the real estate for commercial activities. Commercial rents are also subject to GST in Canada and a collector of such rents (including a non-resident collector) must generally remit GST to the applicable taxation authority. Many businesses can recover GST that is related to commercial activities through a system of input tax credits.

In Canada, a seller has an obligation to remit GST that it has collected from a purchaser. If a seller is a non-resident, is not a GST registrant in Canada, and is not carrying on a business in Canada, the purchaser may be required to self-assess for GST payable on the transaction. Non-residents must register under Canada's GST legislation and charge and collect GST if they make taxable supplies in the course of a business carried on in Canada. A foreign firm with a permanent establishment in Canada is deemed a resident of Canada for GST purposes with respect to activities carried on by that establishment in Canada. A business with a Canadian branch may be required to register for GST and collect GST on supplies made through the permanent establishment. Non-resident registrants that do not have a permanent establishment in Canada are required to post security with the Canada Revenue Agency to meet collection and remittance obligations.

Harmonised sales tax

In some provinces, provincial sales taxes have been 'harmonised' with the GST and are collected by the federal government as a single tax known as HST. In provinces where the

HST exists, HST (which includes the 5 per cent GST) is applied to the purchase of real property, rather than GST alone. The application of HST generally parallels that of the GST; for instance, HST does not generally apply to the sale of used residential housing, but HST will apply to the sale or lease of commercial properties subject to the ability of the payee to recover portions of the HST through input tax credits. As of 1 June 2016, four provinces will charge HST at the following rates: Nova Scotia at 15 per cent; and Ontario, New Brunswick and Newfoundland and Labrador at 13 per cent. In the provinces where the HST does not exist, provincial sales tax does not apply to the purchase of real property.

Municipal tax

In Ontario, the Municipal Act allows municipalities to charge an annual tax on real property. This tax (known as realty tax) is calculated by multiplying the assessed value of the real property by the 'mill rate', which is established yearly based on the financial needs of the municipality. Such taxes can be substantial.

vii Regulatory considerations

Foreign ownership

Restrictions on foreign ownership of land

Ownership of real property is generally a provincial rather than a federal matter in Canada. British Columbia, Ontario, Newfoundland, New Brunswick and Nova Scotia do not have restrictions on foreign ownership of land.

Alberta, Saskatchewan, Manitoba and Prince Edward Island have rules restricting land ownership, generally aimed at farming lands. Alberta restricts the purchase of farmland over a certain size by foreign residents or foreign-controlled corporations. Saskatchewan restricts the acquisition of farmland by non-residents and even certain Canadian-owned entities to 10 acres. A Canadian pension fund and Canadian corporations whose primary business is not farming or are not 100 per cent owned by Canadians are deemed to be non-Canadian owned entities under the Saskatchewan rules.

Manitoba also restricts foreign ownership of farmland to 40 acres. Quebec has even more parochially regulated farmland ownership prohibiting non-Quebec residents from acquiring more than four contiguous hectares (about 10 acres). Prince Edward Island restricts non-residents of PEI from owning more than five acres or 165 feet of shore frontage.

The rapid rise in residential housing prices in Vancouver and Toronto has given rise to pressure on governments to consider restrictions of foreign investors purchasing housing, particularly if it is not actively occupied. British Columbia has just instituted a 15 per cent surcharge on foreign buyers of residential real estate in Vancouver. The federal government announced in June 2016 it is studying the issue.

General regulatory regimes

Competition Act pre-merger notification thresholds

The acquisition of real property can give rise to a pre-acquisition filing with the Canadian Competition Bureau if both the transaction and the parties to the transaction exceed certain asset size or revenue criteria. Generally, a pre-closing filing must be made if:

a the acquired business or assets in Canada have a value or generate gross revenue in Canada in excess of C$87 million (in 2016); and

b the parties to the transaction (and their affiliates) have:

- aggregate assets in Canada (book value); or
- gross revenues in, from or into Canada in excess of C$400 million.

The initial review period is 30 days although extensions are common if there are any competitive concerns.

If certain thresholds of book value or gross revenues of either party are exceeded, the Competition Bureau examines various factors to determine whether an acquisition will result in a substantial lessening or prevention of competition in the relevant market. A purchaser or seller (or both) may be required to provide prior written notice to the Competition Bureau of a proposed transaction. Real estate has not been historically a sector that has given rise to refusals or divestiture orders.

Investment Canada Act pre-merger ministerial approval threshold

The direct acquisition of control of a business in Canada by a non-Canadian may require the prior approval of the Minister of Industry under the Investment Canada Act depending on:

a the enterprise value of the business (if the acquirer is not a state-owned enterprise);

b the book value of the business (if the acquirer is considered to be a state-owned enterprise or is not a WTO investor); or

c whether the business is in a sensitive sector (real estate is not a sensitive sector for this purpose).

The current enterprise value threshold is C$600 million so only very large transactions would typically be caught. This threshold is moving to C$1 billion up in stages until 2019. Enterprise value of a business in broad terms is the sum of debt assumed and amounts paid.

The book value threshold applicable to state-owned enterprise, based on the prior year financial statements of the target Canadian business, is C$375 million for 2016 (and C$5 million for non-WTO investors).

Whether real estate assets constitute a business is a question of fact and will largely depend on whether employees are acquired along with the real estate. A hotel is a business whereas an office tower may not be if all services are outsourced and no employees are acquired.

If the transaction results in the acquisition of control of a Canadian business by a non-Canadian but does not require prior approval (i.e., the value of the assets is below the applicable threshold), a notice of investment must be filed within 30 days after closing.

All acquisitions of a Canadian business by a non-Canadian can be subject to review on national security grounds on a discretionary basis regardless of the value of the acquisition.

V OUTLOOK

Property prices in Canada continue to climb so that we are expecting Canadian pension plans to continue to lighten their Canadian real estate allocation to foreign buyers prepared to pay exceptional premiums in the context of a lower Canadian dollar. The absence of US REITs in this mix has been notable. We also expect to see weaker performing REITs consolidated by their more strongly performing competitors. However, the whole real estate sector has had a spectacular decade driven in part by historically low interest rates. Will the ability to refinance mortgages at historically low rates continue indefinitely? Will yield-hungry investors go elsewhere if Canadian rates rise on the back of a stronger US economy?

Chapter 5

CHINA

Sammuel (Xiyong) Zhao[1]

I LEGAL ANALYSIS OF REITS IN CHINA

REITs (real estate investment trusts), are real estate investment and financing products that are currently widespread. REITs have advantageous functions in the real estate market in that they can effectively channel funds to real estate companies, diversify the risks of real estate mortgages and loans, and provide a convenient way for minority investors to invest in the real estate industry. However, due to legal obstacles, REITs have not developed well in China.

II INTRODUCTION: ORIGINS AND DEVELOPMENT OF REITS IN CHINA

REITs are a type of trust plan in which funds from specific investors are collected through the issuance of securities and invested in income-producing real estate. REITs implement a capital investment plan on real estate managed by professionals in which holders of REITs can acquire the income of business operations, for example, sales and lease of properties in the form of dividends proportionately.[2] It is worth noting that the terms trust and fund have specific legal definitions under Chinese law. It is not necessary for REITs to adopt the forms of trust or fund under Chinese law. A wide range of legal vehicles can be adopted, for example, corporation, collective trust or contractual fund.

REITs originated in the United States in the 1960s and were later introduced and developed in Australia, Europe, Japan and Hong Kong through statutory laws. REITs, as a financing product, can greatly reduce the cost of property possession for real property developers, provide an effective method of financing and a convenient way for minority investors in the real estate to share income, reduce the financial risk as the consequence of

1 Sammuel (Xiyong) Zhao is a partner at JunHe LLP.

2 Zhirong Mao, 'Analysis of the Development of REITs in China', Shenzhen Stock Exchange Research Institute, 20 September 2004.

mortgages provided by the bank, and ensure the sustainable development of the real estate industry. Considering the advantages of REITs, the Chinese government has established the REITs system and has run pilot projects. The innovative nature of REITs was discussed, particularly during the period of economic structural reform, which focused on the control of the real estate market. On 14 February 2007, the China Banking Regulatory Commission (CBRC) lent its support to the idea of trust investment companies engaging in innovative business, namely through the use of REITs.[3] During 2008, the real property price first dropped and then went up, and it was because of this that the State Council, the People's Bank of China (the Central Bank) and the CBRC issued regulatory documents on the piloting work of REITs.[4] Since 2010, the government has been enforcing a stringent readjustment and control policy over the real estate market through the restriction on the sales and mortgages of real property. As a result of this policy, the banks tightened their mortgage and loan policies and the financing costs for real estate companies increased. The fund shortage in the real estate market significantly affected the sales of real property. Under such circumstances, the Chinese government re-emphasised the development of REITs in 2014.[5]

3 CBRC, 'Notice of China Banking Regulatory Commission on the Specific Issues Concerning the Implementation of the Measures for the Administration of Trust Companies and the Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds' (No. 18 [2007] of China Banking Regulatory Commission), 14 February 2007, 'the CBRC encourages the trust and investment companies which have been approved to be reissued new financial licences to initiatively propose trial plans in terms of business innovation and organisational management and, in accordance with the procedure for examination and approval, gives priority to their such innovative business as personal equity investment trust, asset securitisation, overseas financing upon entrustment and real estate investment trust, etc. Any reform measure that promotes the innovation and development of trust and investment companies and institutional supervision will be tried out on them firstly.'

4 General Office of the State Council, Several Opinions of the General Office of the State Council on Promoting the Healthy Development of the Real Estate Market (No. 131 [2008] of the General Office of the State Council), 20 December 2008, 'We shall also encourage real estate development enterprises with good credit records to issue corporate bonds upon approval, and launch pilot real estate investment trust funds to diversify the channels for direct financing'; Central Bank and CBRC, Guiding Opinions of the People's Bank of China and China Banking Regulatory Commission on Further Adjusting the Credit Structure to Promote the Rapid yet Steady Development of the National Economy (No. 92 [2009] of the People's Bank of China), 18 March 2009, 'We need to provide more financing support and financial services for real estate development enterprises which have strength and good reputation to merge or reorganise the relevant enterprises or projects, encourage the real estate development enterprises with good credit record to issue corporate bonds and do the pilot operation of real estate investment trust funds, diversify the channels for real estate development enterprises to raise funds, provide more credit support to the purchase of houses and improved houses, and encourage the purchase of ordinary commercial residential houses.'

5 China Securities Regulatory Commission, Opinions of the China Securities Regulatory Commission on Further Promoting the Innovative Development of Securities Operation Institutions (No. 37 [2014] of the China Securities Regulatory Commission), 13 May 2014. 'Promoting the development of asset management business. Securities operation institutions

III FUNCTIONS OF REITS IN THE CHINESE MARKET

The success of REITs in developed countries and areas such as the United States, Australia, Japan, Singapore and Hong Kong indicates that the characteristics of REITs products are in accordance with the development of the economy and can play an important role in the sustainable development of a real estate industry.

Currently, the financing methods available for Chinese real estate companies are limited and primarily rely on bank loans to real estate developers, collateralised mortgages or financing through private equity funds. Although the financing cost of bank loans is low, it is subject to government policy to a large extent. Once the government imposes stringent control over the real estate market, the availability and conditions for bank loans will be greatly affected, and so will the cash flow of real estate companies. Since lending banks generally require a collateralised mortgage, the ability of real estate companies to finance themselves further becomes impaired.

Additionally, REITs play an important market function in China. As a financing method that has an equity nature, REITs are stable and expedient for the professional operation of real estate projects and investment and will not result in the change of the control power of real estate developers over project companies or projects. Moreover, REITs are also relatively desirable investment products for minority investors as they have flexible trading channels and stable fluidity.

IV LEGAL OBSTACLES TO THE DEVELOPMENT OF REITS IN CHINA

Comparing the experience of REITs in a mature market and the reality in China, the obstacles faced by REITs in China can be categorised into three aspects.

shall innovate and improve asset management business processes, and improve the professional level in product sale, product design, investment operation, post-sales service, and other aspects. Qualified securities operation institutions may develop cross-border or cross-market products, or products covering different asset categories, or adopting diversified investment strategies and differentiated charging structure and charging level. Research shall be conducted to establish the institutional system of real estate investment trusts (REITs) and corresponding product operation mode and program. The investment scope of collective asset management plan shall be broadened. Investment in equities, creditor's rights, and other property rights that are not transferred through stock exchanges shall be allowed'; Central Bank and CBRC, Notice of the People's Bank of China and the China Banking Regulatory Commission on Further Improving Housing Financial Services, 29 September 2014, 'Banking financial institutions shall, under the premise of preventing risks, rationally allocate credit resources, provide support for the real estate enterprises which have good qualifications and operate in good faith to develop and construct ordinary commodity housing, and actively support the reasonable financial needs of the in-process and continuing projects with market prospect. Efforts shall be made to broaden the market-oriented financing channels, and qualified real estate enterprises shall be supported in issuing debt financing instruments in the interbank bond market. The pilot programME of real estate investment trusts shall be conducted in an active and prudential manner.'

i Lack of systematic statutes

The development of REITs in China are faced with obstacles inherent in the legal system. In mature markets, such as Hong Kong and Singapore, the systematic regulations, which regulate the requirements and procedures for the public offering of REITs, have been promulgated. However, no such similar regulations have been issued in China. In relation to trusts, there is a law (the Trust Law) and regulations issued by the CBRC.[6] In relation to securities, there is a law (the Securities Investment Fund Law), a regulation issued by the CSRC,[7] and a regulatory document.[8]

In terms of the practice of REITs in China, the current legal system is not clear and systematic regulations are still absent. In the field of trust law, in the background of separate management for different sectors of financial industry in China, the regulatory documents issued by the CBRC can only regulate private issuance; public issuance is subject to laws and regulations in other fields. However, REITs in other countries are typical public securities exchanged in the public capital market, which are not included in the regulatory scope of the CBRC.

In the field of security law, Article 58 of the Securities Investment Fund Law provides that fund assets can be used for the following investments: first, investment in stocks and bonds listed and traded on a stock exchange; and second, investment in other securities and their derivatives prescribed by the securities regulatory authority of the State Council. However, considering that the majority of REITs' investment flows into the field of immoveable property, it is ambiguous whether REITs fall within the scope of security investment funds prescribed by the Chinese law.

Therefore, the primary obstacle to the development of REITs in China is the lack of systematic and unified regulations. Compared with the practice experience in the field of real estate finance, in order to establish a comprehensive statutory system, REITs would likely be examined from the perspectives of legal structure, regulatory authority, exchange market, ownership structure, limitation on minimal holding, limitation on development, the lowest percentage of real estate investment, and the lowest and highest proportion of profit allocation.

ii Unclear tax policies

Historically, tax preferences have played an important role in the development of REITs. In 1960, President Eisenhower signed a special tax regulation in which REITs were regarded as profit pass-through and double taxation could be avoided. This regulation remains unchanged except for some small modifications, and is regarded as the driving force behind the development of REITs in the United States. REITs in the United States further developed as a result of a series of reforms in relation to housing tax. Tax reform in 1986 allowed REITs to manage and operate real properties directly. In 1993, the restrictions on the investment of pension funds in REITs were removed. These reforms encouraged investors to invest in REITs, which led to a boom in REITs in the 1980s.

6 Measures for the Administration of Trust Companies and Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds.
7 The Administrative Rules on Asset Securitisation by Security Company.
8 The Notice on Further Strengthening the Asset Management Services for Specific Clients Engaged by the Fund Management Companies and their Subsidiaries.

In China, in 2002, the Ministry of Finance and the State Taxation Administration jointly issued the a circular[9] in which the tax preference policy of funds was clarified. First, the price differential income of the fund managers obtained from buying or selling stocks and bonds with funds was temporarily exempted from business tax and enterprise income tax before the end of 2003; second, no individual income tax was to be levied on the price differential income obtained by individual investors serving as fund subscribing and redeeming entities before the levy of individual income tax upon the price differential income from their buying and selling stocks was recovered; third, with respect to the income obtained by the fund from stock dividends and bonuses, the income from the interest of bonds, and the income from the interest of savings deposits, 20 per cent of the individual income tax was to be withheld and remitted by the listed company, enterprise or bank that issued the bonds when it was paying the above income to the fund. As for the income obtained by the investors (including individuals and institutional investors) from funds, individual income tax and enterprise income tax were not to be levied for the time being. Fourth, for investors serving as fund-subscribing and redeeming entities, no stamp duty was to be levied for the time being.

At the end of 2003, the Ministry of Finance and the State Taxation Administration prescribed that from 1 January 2014, the price difference of the incomes of the fund managers obtained from buying or selling stocks and bonds with funds was to be continuously exempted from business tax and enterprise income tax. However, this document applies to securities funds but not explicitly to REITs. In addition, the tax management of the Chinese government over funds and securities largely relies on the issuance of temporary documents, which also leads to an unstable tax policy.

Because Chinese tax collection has not been reformed or modernised, it is impossible to implement the levy based on the system of actual income and net income. The operation of REITs is related to a variety of transaction processes that result in a heavier tax burden. In this respect, although REITs may reduce the income tax levied on the fund, the company incorporated by trust that owns multiple properties would be liable for corporation income tax. Moreover, a transaction tax may arise from the property transactions during the process of REITs restructuring. In addition, housing tax is inevitable once rents from the property are taken during the operation of REITs.

Since it is necessary for the restructuring of REITs to go through the procedures of assets transfers, if multiple taxes cannot be avoided, the profits of REITs products and other derivative asset securitisation products cannot be guaranteed to a desirable extent. As a consequence, REITs cannot be successfully popularised in China.

iii Uncertainties of legal subject status

Another obstacle that lies in the development of REITs is that REITs are not regarded as a legal entity. At present, the investment fund is not a corporation, or even a legal entity, and an investment collection is not regarded as a legal entity in the Chinese law system. No legal document has touched upon this issue so far.

There is no clear definition of a fund in the Securities Investment Fund Law, which is the only law related to funds. On the contrary, the legal system tends to define a fund as a

9 Ministry of Finance and State Taxation Administration, Circular of the Ministry of Finance and the State Taxation Administration on the Relevant Issues concerning the Taxation on the Open-end Securities Investment Funds ([2002] No. 128), 22 August 2002.

collection of contracts. In these circumstance, it is difficult for REITs to have legal title over real estate considering that they are not legal entities. The relationship between the trustee and fund is contractual and the ownership of real estate is proprietary. It is against the theory of civil law that a proprietary right prevails over a contractual right and may result in legal conflict in practice.

The common solution is to establish a special purpose vehicle (SPV) to hold the ownership of the real estate. At present, in terms of China's Company Law, there is no provision with respect to SPVs. Articles 5, 7 and 12 of the Company Law, effected on 1 January 2006, prescribe that the object of the company is operation of the company and the company must have the business scope that is stated in the business licence. In other words, one of the conceptual differences between Chinese and foreign legal systems is that the company is an operational entity rather than an SPV. The obstacles to legal subject status may only be removed once further improvements to the Chinese legal system are implemented.

V MILESTONE CASES OF REITS PRACTICE IN CHINA

i Zhongxin Qihang

Zhongxin Qihang is a standardised product with a specific asset management plan, which is relatively similar to foreign REITs. It was established on 16 January 2014 upon the approval of the CSRC. Under the legal structure of this asset management plan, the CITIC Securities Company established an asset management plan to invest in a PE fund platform. The PE fund holds the equity of two project companies, which separately owns two properties. This plan adopts the traditional model of 'product plus partnership fund' under which the investors will exit through the standardised IPO of REITs or equity transfer to any other third party at the market price when the plan expires.

The highlight of Zhongxin Qihang is the increased fluidity in the way that it fills the gap between non-standardised products and standardised products, which provides an investment channel for institutional investors, including insurance funds. This also overcomes the restrictions imposed on non-standardised products by the authorities.

However, there are a number of limitations on Zhongxin Qihang. First, Zhongxin Qihang fails to meet the requirements for proceed allocation as return on investment of Zhongxin Qihang is substantially lower than that of standardised REITs, in which the majority of the annual taxable income is allocated to the investor. Second, although Zhongxin Qihang can be listed on the Shenzhen Stock Exchange, the prospectus states that in order to ensure that the number of investors is limited to no more than 200 after each transaction, each transfer of priority beneficiary certificate will no be less than 500,000 shares and each transfer of secondary beneficiary certificate will no be less than 300,000 shares. The par value of every beneficiary certificate is 100 yuan. In other words, the amount of transfer for the primary and secondary beneficiary certificate will not be less than 50 million yuan and 30 million yuan, respectively. These strict thresholds for transfer may substantially impair the fluidity of Zhongxin Qihang. In contrast, foreign standardised REITs provide lower thresholds that function as an important property disposition for the ordinary investor. It is the excellent investment channel for minority investors that brings the opportunities for ordinary investors to share the benefit that arises in the process of urbanisation.

ii Penghua Wanke

Penghua Wanke is the first public REIT in China with the basic structure of a contractual close-end securities fund. It has been listed on the Shenzhen Stock Exchange. During the closed period, Penghua Wanke invested in the equity of a specific single target company. The fund manager signed the agreement with the target company and original shareholders and holds the equity on behalf of the fund.

Compared with a Zhongxin Qihang structure, Penghua Wanke has a lower threshold of subscription and has greater fluidity. The prospectus states the minimal amount of each subscription for each fund account sold by the sales agent of the fund to be no less than 100,000 yuan. The minimal amount of each initial subscription is no less than 100,000 yuan and additional subscription will be no less than 1,000 yuan in direct sales centre. During the fund-raising period, there is no limitation on the accumulated subscription amount for the single fund holder.

In addition, the progress of Penghua Wankes also includes an increase of the proceeding allocation ratio so that 90 per cent of annual allocable profits are allocated to the investors. However, similarly to Zhongxin Qihang, Penghua Wanke has not disclosed that it is entitled to any tax preference outside of the current regulatory scheme.

However, Penghua Wanke has a long way to go to achieve the requirements of international standardised REITs. First, Penghua Wanke is a securities fund rather than an investment trust. Second, the trust deed that is required to establish a REIT is not involved, so no trust legal relationship has been established. As there is no establishment of a trust legal relationship, there is no trust asset. Third, the concepts of custodian and custodian bank are different from the meaning of trustee in the relationship of trust and the powers of which are different. The aforementioned three aspects indicate that due to the lack of the required legal environment and the failure to adopt a complete trust structure, typical REITs in China are currently still remote from the standardised REITs in the international market.

VI TRENDS OF REITS IN CHINA

Despite the advantages of REITs and the need for their implementation, so far no REITs that comply with international standards have been issued because of the legal environment. After reviewing the history and current situation of REITs across the world, it is clear that the development of REITs depends on the establishment of an appropriate legal scheme. REITS in the United States began with legislative activities in the 1960s, as was the case also in Hong Kong, Singapore and Japan. The absence of relevant regulations has resulted in the slow development of REITs in China. Therefore, the promotion of REITs depends on the following improvements in legislation and regulation.

First, the regulatory authority should be determined. Although China has put forward the promotion of REITs for nearly 10 years, it has made little headway. One important reason is that the regulatory authority is not clear. The Central Bank, the CSRC, the CBRC and the Ministry of Construction all intend to be the regulator of REITs. REITs were first promoted by the Central Bank because it intended investors of REITs to be institutional investors; ordinary investors have difficulties investing in REITs and the exchange platform will be the interbank bond market, the fluidity of which is limited. The CBRC and the Ministry of Construction also desire to be the regulator for REITs but they have similar problems as the Central Bank. The CSRC has the comprehensive system for the regulation of securities and funds in Shanghai and Shenzhen Stock Exchange, and this makes the CSRC the most suitable candidate. The issued REITs, such as Zhongxin Qihang, are listed on the Shenzhen Stock Exchange with the approval of the CSRC. In the special structure of the market economy in China, the ambiguity of the regulator always leads to inefficiencies in the promotion of the regulation system. Therefore, determining the regulator and establishing a corresponding legal system as soon as possible are priorities.

Second, the issue of tax preference should be resolved. REITs are entitled to tax exemption in foreign REIT structures for the purpose of maximising the benefits to investors. At present, REITs in China are not regarded as a securities fund and subsequently are not subject to the Securities Investment Fund Law under which tax related to the contractual fund is exempted. Pursuant to the tax system in China, the revenue from the real estate operation will be subject to business tax at 5.5 per cent, housing tax at 12 per cent and business income tax at 25 per cent. If REITs pay tax in accordance with the current tax system, the profit margin will be narrowed, which is not helpful in the cultivation and development of the REITs market. Therefore, the tax exemption or tax preference policy must be achieved through special statutory issuance.

Third, a real estate property registration system should also be established. All the investors have common ownership over the real estate property via REITs in the manner of securities issuance, which means ownership registration will be the issue to be resolved. No restrictions on the ownership registration will exist if the REIT is incorporated as a company. However, in terms of the current legal system, the Chinese government tends to develop contractual REITs, which results in difficulties of ownership registration. For the purpose of ensuring independence of ownership and achieving the effect of judicial separation, a legal system that facilitates ownership registration under the name of REITs should be established. It will answer the concerns of investors regarding the independence of property ownership and avoid the high tax (especially VAT and deed tax) that arises during the process of property transfer, which will reduce the cost of establishment and operation of REITs and subsequently facilitate the issuance and operation of REITs and mortgage financing.

Chapter 6

DENMARK

Hans-Peter Jørgensen and Michael Wejp-Olsen[1]

I OVERVIEW OF THE MARKET

The Danish real estate market is mainly dominated by institutional investors and property funds. The market for office properties is particularly dominated by institutional investors, whereas property funds and private equity firms make a large part of investments in residential and retail properties. Besides these market players, public real estate companies are also active in both the office, residential and retail markets, but to a lesser extent.

Domestic institutional investors have a significant presence in the Danish real estate market, where particularly Danish pension funds are increasing their investments in real estate. Pension funds are not only investing through property funds but are to a large extent investing directly in properties.

Recent years have seen an increasing number of foreign investors entering the Danish real estate market. Investors from Germany, Scandinavia and the United Kingdom particularly are investing in Danish real estate.

Foreign investors are most active in the retail segment focusing mainly on retail properties located in prime locations in Copenhagen. Furthermore, they are increasingly interested in residential properties, mainly larger portfolios, while they account for only a smaller part of the investments in office properties.

International investors tend to stipulate requirements to the transaction documentation deviating from what has previously been customary in Denmark. Transactions involving properties with significant commercial operations, such as hotel or retail properties, require bespoke solutions, which often entails a certain level of complexity as well as a need for thorough preparation. These transactions resemble M&A transactions more than ordinary real estate transfers in terms of structure, complexity, timing and process.

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II RECENT MARKET ACTIVITY

i M&A transactions

One of the largest real estate transactions in Denmark to date took place in 2015 when Novo A/S and TryghedsGruppen SMBA acquired 49.2 per cent of the shares in the privately held real estate company DADES A/S. The value of the transaction remains undisclosed, but DADES owns a portfolio of mainly office and retail properties worth 16.9 billion kroner. The sellers were a number of institutional investors, including banks, pension funds and an insurance company. As part of the transaction, the acquirers committed themselves to contributing additional capital of approximately 1.7 billion kroner for investments in real estate.

In 2013, Rosengårdcentret, Denmark's second-largest shopping centre, was sold to the German-based ECE European Prime Shopping Centre Fund in its first investment in Denmark. Until the transaction, the property had been owned by a large number of private investors. Though undisclosed, the value of the transaction is estimated to be around 2.9 billion kroner. Later in 2013, Danish ATP, who already had an indirect ownership interest through an investment in the ECE Fund, increased its share of ownership in the shopping centre to 25 per cent.

The most significant recent transaction by a public real estate company was Jeudan A/S's acquisition of a property from A.P. Møller – Maersk A/S in 2015 for 585 million kroner. The property, which is under construction, was transferred under a sale-and-leaseback agreement and will, once finished, serve as the domicile for part of the Maersk Group. The transaction brought Jeudan's total property investments in Copenhagen in 2015 to a level of approximately 1.1 billion kroner.

ii Private equity transactions

One property has attracted particular attention in the private equity market in recent years: the Illum property, located in central Copenhagen and housing a luxury department store. In 2011, the Danish private equity fund Solstra Capital Partners, which acquired the Illum property in a distressed sale in 2009, divested the real estate company owning the Illum property for approximately 1.6 billion kroner to the UK-based private equity firm MGPA. Then in 2013, Solstra sold the Illum department store (opco) to Italian retailer La Rinascente, which is part of Thai-based Central Group. In 2015, Central Group acquired the Illum property from BlackRock (who had taken over MGPA in 2014) in a deal with an estimated value of between 2.5 and 3 billion kroner.

Solstra was also involved in another significant transaction when the Magasin property, also housing a major department store, was sold in 2013 to the Danish pension funds ATP and PensionDanmark. The value of the transaction is estimated to be around 2 billion kroner.

Residential properties have also been in focus in the private equity market with transactions involving larger portfolios. The most significant transaction was UK-based Coller Capital's acquisition of the former PFA portfolio containing 22 residential properties in 2015 at an estimated total value of 2.2 billion kroner. The seller was the Norwegian bank DNB that had taken over the portfolio as part of the previous owner's bankruptcy.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Currently, REIT structures are not used in Denmark, but there are a number of publicly traded real estate companies of varying size. The largest one by some distance is Jeudan, with a market capitalisation of around 7.7 billion kroner, total assets of 20.3 billion kroner and annual revenue of 1.2 billion kroner.

Besides Jeudan, only smaller real estate companies are traded publicly, of which none has a market capitalisation exceeding 300 million kroner or revenue exceeding 200 million kroner. These smaller companies do not play roles of any significance in the real estate M&A market, and only Jeudan is of a size to engage in larger transactions.

Jeudan owns both commercial and residential properties in the Copenhagen area. Its portfolio primarily consists of commercial properties, including mainly office properties but with a small part in retail properties. Jeudan's business strategy is to continue investing in primarily office properties in Copenhagen with a long-term investment horizon.

ii Real estate PE firms – footprint and structure

The real estate private equity market in Denmark is dominated by a few local players together with a group of foreign private equity firms. The main local players are Solstra Capital Partners and Nordic Real Estate Partners (NREP), which are both based in Copenhagen. In recent years, NREP has developed to become a pan-Nordic player whereas Solstra Capital Partners has focused on developing a large portfolio of hospitality operations including the Marriott hotel, the Crowne Plaza hotel and the Bella Sky Copenhagen hotel in Copenhagen. Also the Danish operation of German fund Patrizia has been very active in recent years, most recently with the acquisition of the large Gallery K shopping area in Central Copenhagen (transaction value of approximately 1.4 billion kroner). Among the UK-based firms involved in recent major transactions are BlackRock, Coller Capital, Aberdeen, Standard Life, Cubic Properties and Tristan. From Sweden, Niam and Sveafastigheter have recently been party to significant transactions. Private equity investors are focusing their investments on significant retail properties, logistics and larger portfolios of residential properties but have not yet directed their attention towards office properties to any great extent.

IV TRANSACTIONS

i Legal frameworks and deal structures

Typically, a real estate transaction in Denmark is structured either as a direct investment in the form of an asset deal or through a limited liability company or limited partnership in the form of a share purchase. However, limited liability companies are most frequently used for investments in real estate in Denmark as a result of the advantages attached to this structure.

Choice of deal structure depends on various factors, with tax or registration duty aspects being predominant, and which structure is most preferred depends on the circumstances of each specific transaction.

When structured as a share purchase, all the assets and liabilities in the company are transferred to the buyer. On the contrary, when structured as an asset purchase, only the assets and liabilities comprised by the purchase agreement are transferred. The consequence of this is that any latent liabilities and risks, including pollution of the property, are, as the principal rule, not transferred to the buyer. However, in an asset purchase, transfer of any contracts requires consent from the contracting party, which is not necessary in the case of a share purchase with the exception of contracts containing change-of-control clauses. The consent requirement in asset deals can be prevented by a demerger of the assets and liabilities to be transferred, as the Danish Companies Act prescribes mandatory debtor substitution in such cases. Subsequently, the demerged company can be transferred as part of a share deal.

As a result of these factors, the deal structure will often involve a prior corporate restructuring in the form of a demerger or contribution of assets where the relevant property or portfolio of properties is transferred to a separate entity.

A share purchase requires consent from the selling shareholders, whereas an asset purchase can be resolved by the management of the selling company – typically the board of directors – without involving the shareholders. This is presumably the case even if the property in question is the only substantial asset of the company.

An important aspect when structuring a transfer involving residential properties is the tenants' mandatory right of pre-emption according to the Danish Rent Act. For properties with a minimum of 13 residential tenants, or six residential tenants if the property contains only residential tenancies, the tenants have a pre-emption right. Thus, unless the property has been divided into owner-occupied flats according to the Danish Rent Act, the owner must offer the property to the tenants on a cooperative basis before disposing of it to a third party. The tenants must be offered the opportunity to purchase the property on the same terms as any outside purchaser has offered.

The right of pre-emption applies both when the property is transferred, including by merger, and if there is a change of control of the limited liability company owning the property. However, a change of control of a parent company (the holdco) to the property owning company (the propco) will not trigger the tenants' pre-emption right. The shares of the holdco may thus be transferred freely, whereas transfer of the shares in the propco triggers the pre-emption right if there is a change of control (i.e., the majority of the voting rights is transferred). It is a requirement for triggering the pre-emption right for the majority of the votes to be transferred to the same transferee. According to case law, a transfer of all the votes in the propco to three or more separate transferees, whereby none of them acquire control of the company, will thus not trigger the pre-emption right.

A different right of pre-emption applies when transferring residential properties reserved for senior citizens. Such properties must be offered to the municipality prior to a transfer to anyone else, but this pre-emption right does not apply in a transfer of shares in a limited liability company owning the property.

Another important factor in the choice of deal structure is registration fees. Registration fees are payable on the registration of change of ownership and security rights over real estate. A transfer of the property in question will thus trigger a registration fee of 1,660 kroner plus 0.6 per cent of the highest amount of the purchase price or the latest public property value. Registration of a mortgage triggers a registration fee of 1,660 kroner plus 1.5 per cent of the mortgage sum; however, it is generally possible to make deductions corresponding to the value of the mortgages being replaced. By way of contrast, a share transfer of a limited liability company owning a property does not trigger any registration fee. In a change of ownership as part of a corporate restructuring (i.e., merger, demerger, transfer of assets or exchange of shares), the registration fee is reduced to a fixed amount of 1,660 kroner. Hence, the variable part of the registration fee can be avoided by transferring the property in question to a separate company (a special purpose vehicle (SPV)) by way of a demerger or transfer of assets and, subsequently, transferring the shares in the SPV instead of transferring the property directly. This is commonly referred to as the 'drop down' model.

If a transaction involves a real estate company with securities listed on a regulated market in Denmark or another EU Member State, the company may have a duty to disclose the transaction to the market in accordance with the Danish Securities Trading Act. Such a duty to inform the market arises if information about the transaction constitutes inside information.[2] If information on a real estate transaction constitutes inside information the company is required to disclose such information immediately upon relevant circumstances coming into existence or the occurrence of a relevant event, albeit not yet formalised.

ii Acquisition agreement terms

Generally, it can be noted that agreements in Danish real estate M&A and private equity transactions are becoming more detailed and thorough. This is probably due to influence from the increasing number of foreign investors now in the Danish real estate market. Further, there is to a large extent no law regulating such transactions, thus requiring a more thorough description of each party's rights and obligations within the agreement itself.

Consideration is typically cash payment and, if relevant, the buyer's payment of any intercompany loans provided by the seller to the target company. The types of representations and warranties vary to a certain degree depending on whether the transaction is a share deal or an asset deal.

A share purchase agreement will usually contain a number of representations and warranties regarding various corporate matters. These can include the assertion that both the seller and the buyer represent and warrant that they have the requisite power and authority to execute and perform the transaction, and that the transaction will not conflict with any other agreement, applicable law or judgment.

With regard to the shares to be transferred, the seller represents and warrants that it owns and has full title to the shares, that they are duly issued, paid and registered as well as fully paid up and freely transferable, and not subject to any encumbrances. Additionally, with regard to a property company to be transferred, the seller represents and warrants that it is duly incorporated and existing, has never been declared insolvent or bankrupt, has no outstanding equity securities, for example, warrants or convertible debentures, and that no resolution has been passed to change the company's share capital, articles of association or other statutory documents other than as provided for in the share purchase agreement.

In respect of the property, a share purchase agreement will usually contain a representation and warranty to the fact that the company owns and has full and unrestricted title to the property in question. Similarly, an asset purchase agreement usually contains a representation and warranty to the fact that the seller has such ownership and title to the property.

Both share and asset purchase agreements generally contain representations and warranties with regard to the property. Typically, these include that the seller represents and warrants that the property is free from all material encumbrances, easements and mortgage deeds other than as set out in the purchase agreement. Further, they may require that all due

2 Inside information is non-public information that would be likely to have a significant effect on the price of the company's securities.

payments relating to the properties have been paid at the time of closing, including property taxes, and that all lease agreements relating to the properties have been disclosed and are legally binding.

With respect to the property in question, it is customary for the seller to represent that to the seller's knowledge its construction and utilisation is in accordance with applicable law, and also that it is built in accordance with all regional and local development plans applicable to as well as easements registered on the property, and that there are no hidden defects.

With regard to insurance, the seller may represent and warrant that the property is insured at full value and that such insurance policies are and remain in full force and effect and cover the properties in accordance with their terms until closing. Furthermore, the warranty may include that all insurance premiums have been paid when due and there has been no breach of any material terms or conditions.

Other representations and warranties by the seller may concern lease agreements, pending cases or environmental matters relating to the property, and that there are no agreements or rights for sale, options or rights of pre-emption affecting the properties other than the purchase agreement.

Closing conditions will typically include the buyer's obtaining of the necessary external financing, either fully or partially, as well as both seller and buyer documenting board approval of entering into and execution of the agreement. The seller may further be required to present an updated shareholders' register displaying the transaction, whereas the buyer must document the unconditional transfer of the purchase price to the seller's bank.

A mutual closing condition relating to a transaction involving residential properties may be that the tenants of the residential property in question do not exercise their pre-emption right according to the Danish Rent Act. When transferring a portfolio of residential properties, the pre-emption right applies to each individual property. Hence the purchaser will normally require a contractual right to stand down from the entire agreement or benefit from a price reduction if the pre-emption right is exercised for one or more properties.

The purchase agreement may contain an indemnification clause requiring a party to the agreement to hold the other party harmless from and against any loss subject only to the limitations set out in the agreement. The clause may preclude claims regarding consequential and indirect losses, including loss of goodwill, business, anticipated profits and similar losses. Typically, such loss would be determined in accordance with general principles of Danish law, including the principles regarding mitigation of loss and limitation of losses resulting from acts by the party bringing the claim.

Liability may be limited to claims being within agreed time limits or exceeding a certain amount either individually or in aggregate, and there may be a limitation on the aggregate liability, including a limitation of the amount to the total consideration or a percentage thereof. The party may be liable for either the full amount or the excess amount only.

The purchase agreement may exclude liability for certain claims, for example, defects in the property, environmental and pollution matters, and the accuracy of particulars registered with public authorities.

iii Hostile transactions

Hostile transactions rarely occur in Denmark. This is also the case for public real estate companies.

The only recent hostile bid for a public real estate company was William Demant Invest A/S's (WDI) tender offer to purchase all the shares in Jeudan in 2012. The tender offer was a consequence of WDI obtaining control of Jeudan, thus triggering the mandatory bid rule requiring the acquirer to make an offer for all the shares in the company. Hence, WDI had no intention of acquiring all the shares in Jeudan and made the tender offer only because it was legally obliged to do so. Therefore, the offer was not at a premium to the market price, and it was thus only hostile in the sense that the board of directors of Jeudan was recommending that the shareholders not accept the offer. Under these circumstances, the result of the tender offer was that WDI further acquired an insignificant number of shares in Jeudan, bringing its total holding to 41.6 per cent of the share capital.

iv Financing considerations

The prevailing way of financing real estate transactions is by way of loans secured by mortgages over the property in question. However, there are certain limits as to how much of the transaction it is possible to finance through mortgage loans. With regard to commercial properties, including office and industrial properties, it is only possible to finance up to 60 per cent of the property's value with mortgage loans according to the Danish Act on Mortgage Loans and Mortgage Bonds. The limit is 80 per cent for residential properties and 40 per cent for other properties, including undeveloped properties.

The rest of the transaction value must be financed in other ways. This will often be through either equity contributions or ordinary second-tier bank financing on less favourable terms than mortgage loans but still with security in the property. In addition to security in the property, lenders may also require other security instruments such as negative pledges, account pledges, share pledges, assignments of receivables and springing mortgages (mortgages initially not registered with the Land Register in order to save registration fees), but this depends on the will of the lender.

When structuring the transaction as an asset purchase, the buyer may legally provide the property as security to the lender that is providing the financing for the transaction. However, this is not necessarily a possibility in the case of a share purchase. Under Danish law, a limited liability company is subject to limitations in terms of financing an acquisition of shares in the company itself. According to the Danish Companies Act, a limited liability company may not, directly or indirectly, provide, *inter alia*, security for a third party's acquisition of shares in the company or its parent. Thus, the target company cannot put up the property as collateral for the buyer's financing of the acquisition. However, subject to certain conditions, the target company is allowed to provide financial assistance. Such legal financial assistance requires shareholder approval and must be provided at arm's length, and the board of directors of the target must issue a statement ensuring that the recipient is credit rated. Finally, the financial assistance may not exceed the funds that can be distributed as dividends, and it must be reasonable having regard to the target company's financial position.

Due to the limitations in the target company's ability to provide financial assistance, the financier of a share purchase will often obtain security in the shares in the target company. Such pledging is not subject to limitations according to the Danish Companies Act.

v Tax considerations

There are significant differences in the tax aspects of a transaction depending on the deal structure.

In an asset deal the seller, domestic or foreign, is taxed on the profit of the sale of the property and there is a right of deduction for losses incurred in this respect; however, the deductibility is limited to other profits on sales of property with the possibility of carrying the loss forward to subsequent income years. Furthermore, the seller is taxed on any recovered depreciations.

In a share deal the seller is not taxed on any profit of sale of the property and, consequently, incurred losses are not deductible. Furthermore, a transfer of shares will not trigger any capital gains tax if (1) the seller is a Danish limited liability company; (2) the transferred company is not listed on a stock exchange; and (3) the selling company holds at least 10 per cent of the shares in the transferred company. If these conditions are not met, the capital gain is taxed at the corporate tax rate of 22 per cent if the seller is a limited liability company.

If the seller is a foreign investor not subject to full tax liability in Denmark, any capital gains from the sale of shares will not be subject to taxation in Denmark. This is as a result of capital gains from shares not being subject to limited tax liability according to Danish tax law.

As a main rule, interest related to commercial activity in a company is tax deductible, but certain limitations apply with regard to the ability to deduct interest, *inter alia*, by thin capitalisation rules. If these rules apply it may be preferable to make a direct investment or invest through a tax transparent entity, for example, a limited partnership.

Corporate restructurings, including a demerger or transfer of assets, made prior to a transaction can be tax-exempted either with or without permission from the Danish tax authorities. However, certain conditions will apply to such tax exemption, including a ban on selling the shares in the demerged or receiving company within three years of the restructuring.

Generally, a transfer of property does not trigger any VAT; however, a sale of building land or newly constructed property is subject to VAT at a rate of 25 per cent of the transfer sum. VAT is not levied on such a transfer if it is part of an entire or partial transfer of business.

No VAT is due on the sale of shares in a company owning real estate, and a share deal does thus not trigger any VAT.

vi Cross-border complications and solutions

Denmark has some firm purchasing restrictions on foreigners' investments in real estate. These restrictions render it practically impossible for many foreign investors to make direct investments in real estate in Denmark without obtaining permission from the Danish Ministry of Justice. It is unlikely that such permission will be granted if the targeted property is purely an investment.

However, the purchasing restrictions do not apply to Danish legal entities owned by foreigners. Hence, foreign investors generally choose to invest in Danish real estate through a Danish company or subsidiary. This can be done even if the sole purpose of the establishment of the company is to acquire the property in question.

V CORPORATE REAL ESTATE

There has been a slight trend to separate corporate real estate from operating companies by way of opco/propco separations. This has primarily been done by companies owned by private equity firms. In real estate-heavy companies such as in the retail sector, private equity-owned companies have tended to separate the company's real estate from the operating company in order to divest either the propco or the opco, or as part of a complete exit from the investment through sales of both to different acquirers. Typically, the separation takes place by way of a demerger or a transfer of assets.

Furthermore, sale-and-leaseback transactions are becoming increasingly popular. Several of the largest Danish companies have engaged in sale-and-leaseback transactions disposing of domicile properties in order to release capital and focus resources on the core business. The acquirers are typically institutional investors and private equity firms.

An example of a significant sale-and-leaseback transaction is DONG's disposal of its largest domicile to Danish ATP in 2013 for 1.9 billion kroner, including a 15-year, non-terminable lease agreement. DONG's disposal of the domicile was part of a plan to divest non-core activities and reduce the company's net interest-bearing debt.

VI OUTLOOK

It is expected that the increasing focus on M&A and private equity transactions in the real estate market will continue. Additionally, the significant number of foreign investors in the Danish real estate market is expected to increase with the entrance of several investors in the form of both private equity firms and property funds.

Until now, retail and residential properties have been the main focus of investments, particularly by foreign investors. Domestic institutional investors have begun directing their attention towards office properties and this trend is expected to continue with foreign investors also shifting focus to such properties. Another trend is the conversion of office properties to residential properties as a result of increasing required rates of return and decreasing rent levels for certain office properties.

The number of transactions involving properties in prime locations is not expected to remain at the same high level because of the lower supply of such properties.

Chapter 7

GERMANY

Stefan Feuerriegel[1]

I OVERVIEW OF THE MARKET

The German real estate M&A market has been growing continually since the financial crisis from 2008 to 2010. According to the EY Trend Barometer, the total volume of transactions reached about €80 billion in 2015, with €56 billion being commercial and €24 billion being residential property transactions.

As recent market activity shows, significant activity has shifted to stock exchange-oriented transactions. Several significant transactions have been executed by Germany's largest housing companies, with the single biggest transaction being Vonovia SE trying to take over Deutsche Wohnen AG for €14 billion, however, ultimately not being executed. Moreover, DIC Asset AG had been purchasing shares in WCM AG and now holds around 20 per cent. Thus, DIC has become the biggest shareholder of WCM AG.

All in all, special funds, real estate funds and real estate operating companies (REOCs) make up almost 50 per cent of the commercial transaction volume, while only 5 per cent of the deals are concluded by private equity investors.

II RECENT MARKET ACTIVITY

i M&A transactions

In 2014, two commercial portfolios with a value of €1 billion each were sold. The Mars portfolio, consisting of 24 office buildings and two hotels, was sold to Kildare Partners by Deutsche Bank and the Leo I portfolio, consisting, *inter alia*, of public buildings in Frankfurt, was sold to PATRIZIA Immobilien AG by Commerz Real. The single biggest transaction of

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2015 was the sale of the retail store company Galeria Kaufhof by Hudson's Bay Company to Simon Property Group for €2.4 billion. Moreover, Alstria took over Deutsche Office AG. The transaction had a volume of €1.7 billion.

2015 was also a busy year for some of the biggest German housing REOCs, especially Vonovia SE, the single biggest private landlord. In March, Deutsche Annington Immobilien SE (now Vonovia SE) took over Gagfah SA for €3.9 billion before purchasing the Süddeutsche Wohnen Group (with 20,000 apartments) from PATRIZIA Immobilien AG for €1.9 billion. In September, LEG Immobilien AG planned a merger with Deutsche Wohnen AG, while Vonovia SE made a hostile takeover offer to the shareholders of Deutsche Wohnen AG in December. The offer had a total volume of €14 billion. Ultimately, neither of the latter deals was executed.

In 2015 and 2016 a couple of large retail portfolios have been sold. One of the most active players in this field was PATRIZIA, which purchased three portfolios of a total value of €750 million between December 2015 and July 2016.

ii Private equity transactions

Generally, private equity transactions have not been as attractive for private equity investors in recent years. Strong demand and the corresponding competition between investors has led to rising prices and falling yields. Thus, market activity has shifted to asset management companies and funds investing in real estate as they typically are not as demanding as private equity investors when it comes to rates of return.

However, one significant transaction with a total volume of €3.5 billion was Allianz Capital Partners, together with three co-investors, taking over Tank & Rast (with 350 petrol stations, 390 motorway service areas and 50 hotels).

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Under German law, REITs have to be organised as stock companies; 75 per cent of their income has to originate from real estate, they have to distribute 90 per cent of their profit and their equity ratio has to amount to at least 45 per cent. Moreover, German REITs cannot invest in apartments that were built before 31 December 2006. Finally, in order to allow small investors to invest in real estate assets, a certain number of shares has to be free floating (15 per cent; by the time of the IPO, 25 per cent)[2] and a single shareholder cannot hold more than 10 per cent of the total shares. If a stock company fulfils these requirements, neither corporate nor trade tax are invoked by the REITs' activities. Only the shareholders' income is assessed. These strict requirements have led to only a small number of REIT AGs being formed. Currently, only a handful REITs are listed on the stock exchange and have a total market value of €1.2 billion, while the biggest German REIT, Alstria Office AG, has a stock market value of around €780 million.[3] The other German REITs, such as Fair Value REIT AG and Hamborner REIT AG, play an even smaller role in the market.

2 Article 11 (1) of the German REIT Act.

3 All figures as per the end of 2014.

Some of the biggest German REOCs under German law are UnionInvestment, Deka Investment, Deutsche Bank AG and the quickly growing Patrizia Immobilien AG. Often, REOCs with their business focus in Germany are not constituted under German law. Driven by tax considerations, real estate companies are generally constituted as funds under Luxembourg or Dutch law. Open-ended funds are a common form of investment, such as the ECE European Prime Shopping Centre Funds I and II, Wertgrund Wohnselect and Grundbesitz Europa, and Morgan Stanley Real Estate Funds. German open-ended funds held around €82 billion-worth of property worldwide after a record volume of sales of €5.1 billion in 2014. They are very attractive for investors: from December 2014 to April 2015, almost €3 billion have been invested. However, 18 funds have entered their liquidation phase and property worth around €10 billion has to be sold in 2017.

Activities of open-ended funds have been subject to a shift in regulation in recent years. After the financial crisis, the EU adopted the Directive on Alternative Investment Fund Managers in 2011. Germany implemented the regulations in 2013 by issuing the Code on Capital Investments (KAGB). In the KAGB, a network of detailed provisions was established as it applies to all forms of investment funds and brings change to multiple regulatory aspects. The most significant changes for directors of REOCs operating investment funds are the duties of conduct and the obligation to implement organisation of risk management separate from the portfolio management. Also, various distribution regulations were implemented and now also apply to private placements and not only to public distribution.

With regards to the business strategy and the types of property transferred by German REOCs, commercial property, such as offices and shops, makes up about 70 per cent of the transactions. Being commercial property, hotels have been more and more focused on by REOCs. Recent studies predict, however, that as residential construction is currently and will potentially be more heavily subsidised by the government, residential property will increase its market share significantly in the coming years.

ii Real estate PE firms – footprint and structure

As stated above, private equity firms investing heavily in the German market are rare at the moment. Bigger players include Blackstone, Cerberus and Patron Capital. With regard to their structure, the same principles apply: choosing a company structure is highly tax-driven, with most private equity firms being offshore firms or founded under Luxembourg or Dutch law.

IV TRANSACTIONS

i Legal frameworks and deal structures

Typically, negotiations begin with structured tender offers. Parties often agree on exclusive or co-exclusive periods after an initial offer in order to conduct due diligence. Exclusive periods last for around six to eight weeks, after which the seller has to accept one of the offers from the prospective buyers before the final negotiations on the sale and purchase agreement begin.

It is common for the seller to determine the manner in which the object of purchase – either a single property or a portfolio – is transferred to the buyer. Under German law, this can either be done by an asset deal or a share deal. When transferring real estate in an asset deal, one company directly sells the property to another company while in a share deal, the company owning the property is sold. Both structures are equally common as they both offer certain advantages and disadvantages.

An asset deal will achieve a step up to the fair market value of the real estate but will usually result in higher exit taxes for sellers. Also, an asset deal will always invoke real estate transfer tax (RETT) (see Section IV.v, *infra*) while a share deal might mitigate it if properly structured. The rate of RETT depends on the location of the real estate and rates in the 16 German federal states currently differ between 3.5 to 6.5 per cent.[4] However, a share deal will require more comprehensive due diligence as not only the property itself but also the company has to be assessed extensively. Moreover, depending on the company structure, there might be a liability for contributions under company law. When it comes to formal requirements, an asset deal has to be notarised while in a share deal the formal requirements depend on the company structure – a notarisation is only necessary if one of the companies sold is a limited liability company (GmbH). Common share deal structures that mitigate RETT are selling no more than 94.9 per cent of the interest of a propco to one single investor (or a group of affiliated investors) or, particularly if the propco is established in the legal form of a partnership, the seller remaining a minority shareholder of 5.1 per cent for at least five years.

A typical share deal structure consists of a direct acquisition, for example, if a subsidiary operating the property that the parties want to transfer is sold. Usually, sold companies are held by propcos, which are structured as German limited partnerships (GmbH & Co KGs), GmbHs, Luxembourg limited liability companies (Sàrls) or Dutch limited liability companies (BVs).

However, the transactions in the housing sector mentioned in Section II.i, *supra* were direct mergers, whereas the transactions planned but not executed would have been share purchases (for hostile takeovers, see Section IV.iii, *infra*).

Another common form of investment is a forward transaction in which undeveloped real estate is purchased, then developed and afterwards resold to a third party.

ii Acquisition agreement terms

German real estate is listed in the land register. The person registered as owner in the land register is deemed the owner except where the purchaser has positive knowledge to the contrary. Accordingly, the review of title and title guarantees do not play a significant role in German asset deal transactions. This is different in share deal acquisitions, where there is no such good faith with regards to the shares; however, even in these cases an integral part of the due diligence is that the propco must have purchased the real property from the registered owner. Accordingly, the typical agreement starts with a detailed summary of the entries in the land register or – especially in bigger transactions – by making reference to land register excerpts. This is associated with the most important part of the purchase agreement: guarantees and warranties, typically including that the property is not encumbered (neither easements nor mortgages).

Under current market conditions, the model for dispositions of real estate is that they are sold 'as is' and only few warranties and representations are given, and mostly these are knowledge-based. Typical warranties and representations include that:

a there are no outstanding administrative orders with regards to the property;

4 Mostly around 5 per cent, but many states have recently increased this or announced increases.

b there are no written complaints by authorities that the current development does not comply with building laws; and
c the seller has no knowledge that the construction has not been carried out in accordance with the building permit.

Liability for hazardous materials or second world war munitions, for example, tends to be excluded, whereas German judgments require that any such known defects need to be disclosed for the purchaser to avoid fraud.

German law provides for an automatic transfer of the lease agreements concluded for the respective real property from the seller to the purchaser, and also for transactions by way of asset deal. Given the importance of the lease agreement and its cash flow, the most important warranties and representations are very often those connected with the lease agreements. Typical warranties and representations include:
a the completeness and correctness of a list of lease agreements;
b the payments thereunder within the months or years before signing; and
c the absence of disputes or counterclaims made within a certain period before signing.

Another peculiarity of German law is that lease agreements for real estate with a term of more than one year need to be in writing. This generally includes all agreements between lessors and lessees, and also all amendments. Any oral or tacit change therefore could form a breach of written form requirements. A breach of written form does not mean that the lease agreement would become invalid, but both parties would be in a position to terminate the agreement becoming effective within about six months from the notice of termination. This can potentially cause major issues for investors (as well as for lessees) and can bring the bankability of a transaction into question. The most frequent breaches of the written form requirement are the incompleteness of annexes or later oral changes. Accordingly, the absence of oral or tacit changes to the lease agreement is one of the typical warranties in German acquisition agreements.

Another aspect requiring careful drafting is the purchase price, its calculation and its becoming due. Asset deal transactions need – as laid out above – to be notarised in order to be valid. The execution of an agreement for the acquisition of real estate by way of an asset deal is usually in the hands of the notary public, who also controls the fulfilment of the conditions for the purchase price to become due. The notary public is therefore not only required in order to notarise the asset purchase agreement but is also responsible for bringing about maturity, *inter alia*, by gathering waivers of statutory or pre-emption rights, registering a priority notice in order to secure the transfer of property, and ensuring he or she has all the documents in order to remove encumbrances in the land register that will not be taken over by the purchaser.

When drafting a share purchase agreement, inclusion of a specification of the company's assets and their description is recommended in order to determine the seller's liability. The catalogue of guarantees and warranties is more extensive than when conducting an asset deal as not only guarantees with regards to property itself but also to the shares that are transferred have to be included. Typical guarantees include that:
a the shares exist;
b they are not encumbered;
c the share capital is fully paid;
d the current shareholders' agreement is complete and correct;
e the company is not bankrupt;

f there are no intercompany agreements in place; and
g the list of shareholders is complete and correct.

The purchase price falling due cannot be decided by a notary public as a notary public is not required in all such cases. Thus, the parties have to take measures (especially the purchaser, who typically wants to ensure that it gets a good deal for the purchase price) in order to bring about maturity. Typical prerequisite requirements are the release from encumbrances and negative clearance (as no priority notice can be registered).

When it comes to the calculation of the purchase price, several forms of purchase price adjustments can be considered. Parties only seldom agree on a locked-box calculation but rather agree on a potential adjustment of the purchase price with the help of projections.

Usually, sellers seek to limit their liability. Typically, there are several limitations such as a combination of thresholds for single breaches, minimum amounts of claims for multiple breaches and overall caps. Whereas the amounts for the thresholds mainly depend on the overall deal volume, the overall cap very often is equivalent to a percentage of the purchase price. Whereas for some years, caps of 15 to 20 per cent were very often agreed, in recent months and years caps of 10 per cent and below have become more frequent.

Terms for the prescription of claims vary mostly between 12 and 24 months after closing of a transaction.

Other typical provisions to limit liability are the exclusion of any claims for facts disclosed before signing or for those claims for which the purchaser can seek indemnities against third parties, such as insurances.

Regardless of the acquisition structure and term, parties focus more and more on warranty insurances, especially in distressed M&A situations. By this, financial pressure is lifted off the distressed seller. This is of special interest to distressed sellers and also sellers who intend to dissolve the selling entity shortly after closing.

iii Hostile transactions

The planned transaction by Vonovia SE to take over Deutsche Wohnen AG would have been a hostile transaction. After LEG Immobilien and Deutsche Wohnen AG published plans to merge in October 2015, Vonovia SE resolved a capital increase in order to offer to purchase the shares from the shareholders of Deutsche Wohnen AG. The offer had a volume of €14 billion. As of February 2016, the required acceptance rate of 50 per cent had not been reached. Thus, the attempt hostile takeover failed.

iv Financing considerations

Recent years show more equity-oriented transactions. Typically, deals are nowadays only financed by borrowed capital up to a level of around 50 to 60 per cent. Moreover, finance by insurances has become more and more attractive, whereas the number of transactions being mezzanine or bridge financed has decreased.

Market players for the bank financing of real estate acquisitions are typically mortgage banks. Their regulations provide for a maximum loan-to-value ratio of 60 per cent if they want to issue credit notes. Since the margins are comparable and low in the long term for these kinds of mortgage loans, the equity proportion is very often no less than 40 per cent.

Another impact bank financing by mortgage banks has on real estate investment relates to the need for the mortgages to rank prior to any encumbrances in the land register that may have an impact on the enforceability of the mortgage or the value of the property.

This can very often be the case in relation to easements in favour of tenants. Mortgages banks have developed a standard for tenant easements that they usually accept. If these requirements are not met, the cost for financing are typically slightly higher.

v Tax considerations

Under German law, two major tax issues have to be tackled in almost every transaction: RETT and trade tax.

RETT is generally triggered on both the purchase of real estate in an asset deal and the purchase of at least 95 per cent of shares in a company owning German real estate.[5] The amount rate of RETT depends on the location of the real estate as rates differs in the different federal states. An asset deal always invokes RETT, and even the indirect purchase of property in a share deal can be liable for RETT. As a general rule, RETT is invoked when 95 per cent or more of the interest in a property company organised as a partnership (KG) is transferred to new shareholders.[6] The same applies when 95 per cent or more of the shares in a GmbH are purchased by one purchaser (or related parties). In order to avoid RETT in this situation, the parties can implement a 'RETT-blocker structure', usually involving an unrelated third party acquiring at least 5.1 per cent of a German propco. Real estate investments made by a group of unrelated investors enhance the opportunities to mitigate RETT in many transactions. However, under all circumstances, even blocker structures are considered taxable, which is why, in each case, a tax lawyer should advise on the transaction.

The income of a German corporation is generally subject to German corporate income tax and a solidarity surcharge at a combined rate of 15.825 per cent, and a municipal trade tax between approximately 7 and 17 per cent (depending on location, but in most cities around 15 per cent). However, companies exclusively generating income from the lease of real estate can usually apply for an exemption from trade tax.[7] However, this requires that only real estate be leased. If the lessor lets fixtures or supplies services to the lessee that are needed for the operation of the business itself, this could lead to trade tax liability under German tax law. Typical examples are the furniture, fixtures and equipment (FF&E) of hotels. In order to avoid trade tax, propcos are usually separated from opcos, or beneficial ownership of detrimental assets is transferred to the tenant.

vi Cross-border complications and solutions

Non-German resident investors are generally limited to tax liability in Germany on income from a lease, resulting only in corporate income tax of 15.825 per cent. It is important to avoid the creation of a permanent establishment in Germany, for example, by not maintaining the place of management or services, or employees in Germany. Should this not be the case, income may be additionally subject to trade tax unless the specific exemption applies. It is common therefore to use foreign corporations for the acquisition of German real estate having their place of management outside of Germany.

However, it may also be possible to shift the place of management of a propco that was incorporated under German law (GmbH or GmbH & Co KG) to a location outside Germany in order to have a more robust trade tax structure.

5 Article 11(3) of the German Real Estate Transfer Tax Code (the RETT Code).

6 Article 1(2a) of the RETT Code.

7 Article 9, No. 1, sentence 2 of the German Trade Tax Code.

Foreign investors should observe the strict German 'anti-treaty shopping rules', which require foreign investors, broadly speaking, to satisfy certain substance and economic reason tests to benefit from the exemption from or reduction of German withholding tax on dividends under the Parent–Subsidiary Directive[8] or applicable double tax treaties.[9] Therefore, investors in German real estate usually structure acquisitions to avoid the need for cash repatriations by way of dividends to be distributed by German-resident corporations. Preferred structures to repatriate cash are shareholder loans benefiting from the absence of German withholding tax on regular interest payments and the repayment of debt. However, also as a result of the global BEPS discussions and its upcoming implementation into German law, financing structures need to be carefully structured and monitored to ensure exemption from withholding tax of interest payments and their tax deductibility. Hybrid financing instruments (e.g., profit participating loans) into Germany can create negative tax effects.

V CORPORATE REAL ESTATE

As mentioned above, in order to avoid trade tax, the company owning the property should be separated from the company operating the property. This tax issue can be tackled by implementing such propco/opco structures. Moreover, it is easier to transfer the property by selling the opco to another propco. Most propcos avoid German taxation by being structured as Sàrls or BVs and only holding the opcos.

Particularly when transferring hotels or shopping centres, careful attention has to be paid to the corporate real estate structure. Not only are propcos and opcos involved, but multiple companies provide the hotel with its FF&E by lease contracts.

VI OUTLOOK

The market outlook is positive, the reasons being the consistently low interest rate and therefore cheap financing, and the positive economic outlook (due to low unemployment rate and a predicted economic growth of 2 per cent). Moreover, demand should be steady as the consumer climate is positive because of very low oil prices and growth of the total population from immigration. Therefore, the total volume of transactions will depend on supply, and the rate of return is expected to decline even further.

A greater question is whether the Brexit will have an impact on the real estate market. Whereas it will most likely have an impact on the London and UK real estate market, and may potentially also influence the landscape of financial institutions in Europe, the German and other large developed markets such as France may potentially continue to be regarded as 'safe harbours'.

8 The Directive on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, first adopted by the European Union on 23 July 1990 (90/435/EC) and later amended on 22 December 2003 (2003/123/EC) and on 20 November 2006 (2006/98/EC).

9 Article 50d(3) of the German Income Tax Code.

Chapter 8

INDIA

Cyril Shroff, Reeba Chacko, Nagavalli G and Vandana Sekhri[1]

I OVERVIEW OF THE MARKET

In May 2014, India voted to power a government led by the Bharatiya Janata Party, the first time since 1984 that one party had an outright majority in the Lower House of the Indian parliament. Since coming to power, the government has continually reviewed existing policies across sectors and set the reform agenda rolling, a much-needed impetus specifically against the backdrop of the policy paralysis that had engulfed the country. While many claim that doing business in India has undergone substantial change and the investor sentiment is positive, the markets and the economy in general are sending out mixed signals. Rising non-performing assets, issues in tackling runaway defaulters, allegations of unfulfilled electoral promises on black money, etc. have affected the government's image, despite significant breakthroughs in removing bureaucratic hurdles.

The macroeconomic picture of India's fiscal situation, however, remains fairly stable. According to the economic overview prepared by the Ministry of Finance, the Indian economy exhibited resilient growth of 7.2 per cent in the beginning of financial year 2016, with financial year 2015 having recorded a 178 per cent year-on-year hike in both direct and portfolio foreign investment.[2] The International Monetary Fund too maintained its forecast of India being expected to grow at 7.5 per cent.[3] However, India's benchmark equity indices tell a different story, posting their worst loss in five financial years as foreign investors pulled money out of volatile emerging markets in a flight to safer havens. While the Sensex (the 30-share index) fell by 9.36 per cent in the year 2015–16 (just about better than its

1 Cyril Shroff is managing partner and Reeba Chacko, Nagavalli G and Vandana Sekhri are partners at Cyril Amarchand Mangaldas.

2 Sourced from the Economic Review, India Investment Summit 2016, Ministry of Finance.

3 www.business-standard.com/article/economy-policy/imf-retains-india-s-growth-forecast-at-7-5-for-fy17-116050400031_1.html, last visited on 22 June 2016.

performance in 2011–2012, when it had dropped by 10.5 per cent), the Nifty (the 50-share index) did not fare any better losing by 8.86 per cent, a drop which is only lower than its mark in 2011–12 at 9.23 per cent.[4]

Foreign direct investment (FDI) in the financial year surged at $40 billion (accounting for investment in the equity capital of companies) and at $55.457 billion (accounting for equity capital, investment in unincorporated entities, reinvested earnings and other capital) with a 29 per cent and 23 per cent growth over the previous year (in US-dollar terms), respectively.[5] The year 2015 has been the year of resurgence for private equity (PE) investments in India recording the maximum PE investments received so far since 2007. While the data on inflow across reports from sources such as Bain & Co India Private Limited, VCC Edge (the Annual Report, 2016) and Grant Thornton (The Fourth Wheel, 2016), is varied based on the models of research, the larger picture points to 2015 being the year of reckoning in India's PE space.

In the real estate sector, approximately $5 billion was raised from PE investors across 90 investments in financial year 2015–16.[6] From an FDI point of view, the real estate sector (construction and development) received about $113 million in financial year 2015–16, a decline compared with $769 million in 2014–15 and $1.226 billion in 2013-14.[7]

Trends in PE deals by sub-sectors suggest that there has been an increase in investments in residential projects from 29 per cent in 2013[8] to approximately 71 per cent in 2015.[9] Many investors in the real estate sector have also been in exit mode this year, accounting for 23 per cent of the PE exits by deal value and 14 per cent of the PE exits by volume.[10]

II RECENT MARKET ACTIVITY

The investment activity in the real estate space is no more restricted to asset specific investments and acquisitions. Recently inked large platform-level deals where investor groups cemented relationships with domestic developers and other investors with a long-term exit view are an indication of this trend. These have been primarily driven by investments from sovereign and pension funds.

To quote a few reported examples (along with certain reported details):[11]

4 www.livemint.com/Money/1bzMlwtuBh8RvgH1W2bLXI/Worst-loss-in-five-years-for-Sensex.html, last visited on 22 June 2016.

5 http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_JanuaryFebruaryMarch2016.pdf, last visited on 22 June 2016.

6 Sourced from Venture Intelligence – PE Trends 2016; www.ventureintelligence.com/downloads/pe-trend-report-2016.pdf, last visited on 22 June 2016.

7 http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_JanuaryFebruaryMarch2016.pdf, last visited on 22 June 2016.

8 Sourced from the Fourth Wheel, 2016, Grant Thornton.

9 Sourced from Venture Intelligence – PE Trends 2016; www.ventureintelligence.com/downloads/pe-trend-report-2016.pdf, last visited on 22 June 2016.

10 Sourced from The Fourth Wheel, 2016, Grant Thornton.

11 Sourced from Venture Intelligence – PE Trends 2016; www.ventureintelligence.com/downloads/pe-trend-report-2016.pdf, last visited on 22 June 2016.

a Standard Chartered announced an investment of \$302 million in Tata Realty & Infrastructure to form an investment platform of 30,000 billion rupees for building commercial office projects across the country with the aim of subsequently listing such assets through a REIT platform. Under the joint venture, Standard Chartered will have 30 per cent stake and the remaining 70 per cent stake will be with Tata Realty & Infrastructure. The parties plan to deploy the capital in about four years time to develop the project initially in Mumbai or the National Capital Region and will then explore opportunities in Hyderabad, Bangalore and Pune.[12]

b Goldman Sachs committed \$300 million to forming a joint venture with Nitesh Estates Limited (an Indian developer) that would focus on commercial real estate assets.

c Embassy Group and Warburg Pincus inked a warehousing and industrial platform deal with Warburg Pincus investing \$175 million. This partnership will focus on sectors like fast-moving consumer goods, retail, e-commerce, auto-ancillary and third-party logistics. The parties aim to build well-designed and technology-enabled warehouses that will primarily operate on a lease-rental model in major Indian cities like Mumbai, Delhi, Bangalore, Chennai, Pune and Ahmedabad.[13]

d Piramal Realty attracted investments to the tune of \$150 million from Goldman Sachs and \$284 million from Warburg Pincus, focused on residential projects in and around Mumbai.

e IFC, StanChart PE and ADB came to together to invest \$200 million for a 70 per cent stake in Shapoorji Palonji Group with focus on affordable housing projects. The plan is to deploy capital in a span of eight years to develop about 20,000 affordable houses in Mumbai, Pune, National Capital Region, Chennai, Kolkata, Bangalore and Ahmedabad.[14]

Among the bigger transactions concluded this year[15] stood Blackstone's buyout of the Alpha G Corp for acquisition of certain mall projects, joint venture formed between GIC (Singapore sovereign wealth fund) and DLF Home Developers for investing approximately \$300 million, GIC's acquisition of approximately 2 million square feet of an IT SEZ park (Shriram Gateway SEZ) and Blackstone's acquisition of 247Park (in Vikhroli, Mumbai) from HCC and Milestone Capital.

12 www.livemint.com/Companies/N9OhLXjpXLh747hoFkqOSN/Tata-Realty-planning-offic e-projects-REIT-with-StanChart-PE.html, last visited on 22 June 2016.

13 www.business-standard.com/article/pti-stories/embassy-warburg-pincus-join-hands-to-dev elop-industrial-parks-115100801070_1.html, last visited on 22 June 2016.

14 http://articles.economictimes.indiatimes.com/2015-07-31/news/65074465_1_shapoorji-pallonji-group-fdi-inflow-affordable-housing-segment, last visited on 22 June 2016.

15 Sourced from Venture Intelligence – PE Trends 2016; www.ventureintelligence.com/downloads/pe-trend-report-2016.pdf, last visited on 22 June 2016.

III REAL ESTATE ENTITIES/ PLATFORMS

Asset classes in the Indian real estate sector include standalone commercial (comprising business parks, special economic zones, hotels, hospitality, shopping centres, etc.), residential assets or a combination of both in a mixed-used project. Developers have also in the recent past focused on development of full-fledged townships, which cater to a wide variety of investors and customers.

Assets in the Indian real estate market are mostly aggregated at the local level. Development entities either buy from these aggregators or enter into development arrangements with the land owners. Large project requirements are also met through government-assisted acquisitions. Lands are usually held through multiple special purpose vehicles (SPVs) holding real estate assets.

Multi-level holding structures are typically for reasons of consolidation, corporatisation, ease of unbundling, ring-fencing project-specific risks, itemised scalability and future potential to list the holding companies for fund raising.

Typically, investments are held though corporate entities and SPVs, and in businesses without a foreign investment element, through partnership firms and limited liability partnerships driven primarily by tax benefits, low compliance and ease of setting up and winding up.

To boost the sector's fund raising abilities, the Securities and Exchange Board of India (SEBI), in 2014, introduced the real estate investment trusts (REITs) platform, regulated by the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 (the REIT Regulations). REITs are prevalent in various developed jurisdictions aimed at monetising completed commercial real estate asset portfolio. While the REIT Regulations have done well in institutionalising the REIT framework, listing of a real estate portfolio on the REIT platform is not yet a reality.

IV RAISING FINANCE

Avenues for fund raising in the real estate sector are fairly skewed as a result of regulatory hurdles and lack of confidence in the developers, given the manner in which the sector has been operated over the years.

i Issues under various modes of financing

Bank debt

Under the domestic banking laws,[16] scheduled commercial banks are restricted from lending towards the acquisition of land. Further, the promoter contribution towards the equity capital of a company needs to be brought in from the promoter's own resources and the banks are not permitted to grant advances for the acquisition of shares of other companies. With bank funding for land and acquisition of SPVs ruled out, construction development finance is essentially the only area for which bank funding is available, which is more often than not the second step in a real estate transaction. Such restrictions, however, do not apply to non-banking financial companies, which have in the recent past emerged as strong pillars for this segment.

16 Master Circular – Housing Finance issued by the Reserve Bank of India.

External commercial borrowing
Raising debt by way of external commercial borrowings is not permitted for real estate activities (other than for specific special economic zone-related activities), acquisition of land and acquisition of shares. Thus, this funding mechanism is completely unviable for the real estate sector.

Public fund raising
From a public markets point of view, the track record of publicly traded real estate companies is forgettable. While hopes of the market are now pinned on the REIT platform as being the new saviour for the real estate public market space, it is currently too nascent to be a force to reckon with. The regulatory framework governing REITs, the taxation and the foreign exchange regimes requires a fair bit of fine tuning for aligning with the commercial reality of the Indian real estate space:

Setting up of a REIT
Under the extant foreign exchange regulations, while non-residents have now been permitted to invest in REITs, subscribing to REIT units by way of a swap of shares of an SPV (which holds the assets) is not a permitted mode of investment and would require approval from the Foreign Investment Promotion Board (FIPB). This would be a significant hurdle in setting up a REIT with non-resident PE investors.

Investment conditions
Under the current regulatory framework at least 80 per cent of the value of the REIT's assets is to be invested in completed rent-generating assets. Of the remaining 20 per cent, only 10 per cent is permitted to be invested in properties that are under construction or completed but not rent generating. While the general 80:20 break-up is in line with the intent of providing more liquidity and ensuring minimal risk in the hands of a unit holder, REITs are also intended to be a means of revitalising the cash-strapped market for real estate assets, especially under-construction properties. Practically as well, in the case of large office parks that are substantially complete, the under-construction component may need to be carved out to comply with the existing norms. The process might involve regulatory hurdles and significant transaction costs.

Multiple SPV structures
The REIT Regulations permit only single-layer SPV structures to be held by the REIT. Projects held through SPVs for commercial reasons, would need to be unwound to be brought into the REIT. Further, a merger or a swap of the asset into the REIT would expose the partners, if any, to the liabilities of the holding company from other assets that it would not be exposed to under the step-down vehicle structure. Asset transfers may also result in issues relating to tax on dividend distribution or buy-back; where the owner's commercial interest is to retain ownership of a part of the asset, 'REITability' becomes cumbersome. Restructuring of assets to a single level SPV for enabling the REIT would involve significant costs such as stamp duty on asset transfer and merger and asset transfer costs itself.

The SEBI has been in discussions with stakeholders to address the various concerns facing the effectiveness of the REIT platform and brought out on 18 July 2016 a consultation paper to address some key concerns in detail such as:

a raising the number of REIT sponsors, which is now capped at three;
b removing the restriction on the SPV (only in case of such SPV being a holding company) to invest in other SPVs holding the assets;
c aligning the minimum public holding requirement with the requirement under the equity capital markets regime;
d relaxing compliance requirements with respect to related-party transactions; and
e allowing REITs to invest up to 20 per cent in under-construction assets.

Foreign direct investment

FDI is not permitted in real estate business (dealing in immoveable property with the intent of earning profits), construction of farmhouses and trading in transferable development rights. Exceptions to this are investments in construction development projects and earning of rent or income from projects through the leasing of property (without transfer of the same).

The equity investment regime has come a long way since the sector's liberalisation in 2005. Under the 2005 regime, stringent entry conditions such as a minimum capitalisation ($10 million for wholly owned subsidiaries and $5 million for joint ventures) and minimum area requirements (10 hectares for development of serviced housing plots and 50,000 square metres for construction development projects) had made projects below a certain size inaccessible to investors. Exits were available only after the expiry of a lock-in of three years or upon completion of the project, which meant that if the project did not take off for reasons of litigation or lack of consumer interest, the non-resident investor would have to sit out for three years. There also existed regulatory ambiguity on FDI being meant only for greenfield projects and not for brownfield or existing under-construction projects. Exits from projects prior to a period of three years (even through a stake sale between non-residents without repatriation) required approval of the FIPB, which was not very forthcoming given the sensitivities around the sector.

In a significant overhaul in 2014 (first major move in this space for almost a decade), the present government eased minimum area requirements and minimum capitalisation conditions were made applicable from the commencement of the project; however, subsequent tranches of investment could only be brought in until the expiry of 10 years from the commencement of the project. The three-year lock-in was done away with and exits were made possible on completion of trunk infrastructure (roads, water supply, street lighting, drainage and sewage). While easing of entry conditions did help, the greenfield–brownfield ambiguity continued and exits remained an issue, specifically for stalled or litigation-affected projects. The only way out for projects with no trunk infrastructure was approval of the FIPB. Transfers between non-residents during the lock-in period were specifically brought into the approval route. As a positive measure, for the first time, investments in operation and maintenance of completed projects such as shopping centres and business centres were permitted, spiking a lot of interest in a new kind of portfolio. Thus, the FDI regime in construction development until November 2015, when the government brought radical reforms to entry and exits, was marred by exit issues.

In November 2015, the government did away with most of the entry conditions for investments into a project. Investments can now be brought in for each phase separately, a dispensation that has significantly aided developers in obtaining phase-wise funding from different investors. Though investments by non-residents continue to be locked in for a period of three years, exits are permitted if trunk infrastructure in a project is completed. Exits are no more linked to absolute transfer restrictions but are linked to repatriation of funds outside, which means that non-resident investors are permitted to divest stakes to the other non-residents without repatriation of funds, even during the lock-in period. Besides special economic zones and hospitals, where these sectoral conditions do not apply, and industrial parks (a different regime of commercial projects), investments are now permitted in completed projects for operation and maintenance of townships, shopping centres and complexes and business centres, subject to a lock-in of three years.[17] Investments under the FDI route have to comply with pricing guidelines, which prescribe a fair market value cap (determined based on internationally accepted pricing methodology) for exits and restrict non-resident investors from agreeing on assured returns on their investments. With significant liberalisation in the FDI regime, it is expected that deal activity in this sector will pick up.

In the case of industrial parks, while investments are permitted under the automatic route, 66 per cent of the allocable area in the project is required to be dedicated to industrial activity (a specified set of activities), with the park being required to have a minimum of 10 units and no single unit occupying more than 50 per cent of the allocable area. Industrial park investments have to continually undertake compliance analysis and keep only a defined tenant base, which on a practical level is arduous.

Investment through listed non-convertible debentures

The market is seeing a rise in prominence of investments through listed non-convertible debentures (NCDs) subscribed by foreign portfolio investors (FPIs) and non-banking financial companies as a way of issuing in the equity space and at the same time keeping the commercial needs intact. From 2015–16, the corporate bond market has raised about 4,580 billion rupees across 2,975 issues through private placement of NCDs.[18] Under the Indian foreign exchange regulations, FPIs registered with SEBI are permitted to invest in listed or to-be-listed NCDs (with the only exception being investment in unlisted non-convertible debentures issued by an Indian company in the infrastructure sector). This, as an investment route, is separate from the FDI regime and consequently, sectoral caps and conditions, pricing and restrictions on assured returns as applicable to FDI are not applicable to such investments. The NCDs held by the FPIs are required to have a residual maturity of three years, which essentially means that the issuer cannot redeem the NCDs (even through optionality clauses) prior to the expiry of three years. The three-year lock-in, however, is not applicable to the sale of the NCDs by the FPI in favour to domestic investors. Issuance of listed privately placed NCDs is governed by the Companies Act 2013, with listing and disclosure requirements being regulated by the SEBI (Issue and Listing of Debt Securities) Regulations 2008 and the SEBI (Listing, Obligations and Disclosure Requirements) 2015. The three-year lock-in applies only to FPIs and not to domestic non-banking finance companies or other eligible entities. NCDs with less than a one-year maturity are required to comply with the Reserve Bank of India (Issuance of Non-Convertible Debentures), Directions 2010, which prescribe higher compliance requirements such as credit rating or eligibility of the borrower and a restriction on redemption or put option for a period of 90 days from the date of issuance.

To sum up, with traditional debt funding through scheduled commercial banks and external commercial borrowings being more or less in short supply, sentiment for publicly

17 Press Note 12 of 2015 dated 24 November 2015.

18 www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/privatenew.html, last visited on 22 June 2016.

traded real estate companies being weak and REITs still being just a regulatory provision, investments (both equity and debt) in the real estate sector continue to be dominated by PE investors.

ii Impact of the Real Estate (Regulation and Development) Act 2016

A revolutionary change in recent times has been the introduction of the Real Estate (Regulation and Development) Act 2016 (the RERDA), which seeks to protect consumer interests, ensure efficiency in property transactions, improve accountability of developers and boost transparency in the sector, all of which have been long lacking. The RERDA has brought about significant changes to the way real estate transactions would now be undertaken in India. Key changes include:

a establishment of the Real Estate Regulatory Authority in various states in India to regulate real estate transactions;

b registration of real estate projects and real estate agents;

c mandatory disclosure of all registered projects, including details of the promoter, project, layout plan, land status, approvals and agreements, along with details of real estate agents, contractors, architects, structural engineers, etc.;

d promoters or developers being restricted from amending plans and designs without prior consent of consumers;

e developers being required to deposit at least 70 per cent of their funds, including land cost to meet the cost of construction; and

f establishment of fast-track dispute-resolution mechanisms and provision of jurisdiction to consumer courts to hear real estate disputes.

The RERDA also provides for insurance of title of property, which will benefit both consumers and developers if land titles are later found to be defective.

While the RERDA is intended to provide investors much-required developer accountability, from the perspective of the real estate companies, the regulatory burden and compliance costs have significantly gone up, with certain conditions such as depositing 70 per cent of funds, not being practically viable.

V TRANSACTIONS – STRUCTURING CONCERNS

i Equity structures

Traditionally, the real estate sector has been highly regulated for foreign investment. Discouraging speculative activities on land has been a major theme of the regulators. Therefore, foreign debt was highly restrictive and equity also came with conditions related to development milestones and lock-ins, etc.

With FDI conditionalities now significantly liberalised, transactions in the construction development space have more or less become automatic in the truest sense of the word. A lot of acquisition activity is now seen in the acquisition of completed assets. Management of commercial assets as a separate business skill has been gaining ground – amply supported by technology and best global practices. The FDI policy now specifically recognises foreign equity investment for the purposes of operations and maintenance in completed assets. The country has also seen significant restructuring activity in the sector from the point of view of making the real estate spaces more marketable commodities – consolidating assets, segregating marketable assets, restructuring for raising finance, tax structuring, court-based merger, demergers, conversion of LLPs into companies, restructuring partnership interests to permit investments, and capital reduction, etc. have been used to achieve this end.

For investments in completed assets that are part of larger projects, over and above the 'undertaking' test from a taxation standpoint, from an FDI perspective, the asset being hived off should independently qualify as a completed project.

Significant structuring continues to be adopted around promote structures and profit-sharing arrangements to incentivise the developers. It is not uncommon in commercial projects to have asset or property management and development management arrangements with the affiliates, aimed as cash-outs to the developers. Indemnity or holdbacks, escrow structures, representations and warranties and tax considerations (typically around capital gains and withholding taxes), etc., are sector agnostic and would apply to real estate investments and exits as well. Many investors who picked significant stakes in the 2007–2008 bull run are now in exit mode. Due to limited fund life and other constitutional concerns, PE funds are reluctant to give standard representations at the time of exit. Though warranty insurance is slowly gaining traction in India it comes with its own problems, of high premium costs and wide exclusions (including all information known to the investor, taking away from the investor the traditional knowledge exclusion despite diligence).

ii Debt and structured debt

Investors are now looking at debt investments to gain an upside from the business by structuring returns based on business performance or project-based conditions. Being debt, there is downside protection of the principal. Given the fundamental jurisprudence of debt being an absolute obligation to repay, absorbing downside risks remains tricky. Structures with PE investors investing in nominal equity along with private debt are not uncommon. These structures allow investors to exercise control through affirmative voting rights, obtain a board seat as equity holders and receive assured return on their investments as creditors. This not only helps bridge the gap in a company's capital structure but is also commercially viable for investors as it occupies a place between senior debt and equity in terms of security, returns and influence. There are instances where investments are purely into debt but veto matters are shaped as negative consent rights, which are standard in the lending arena.

NCDs usually earn mid to high yields through various combinations of cash coupon coupled with redemption premium, cash flow or profit-linked coupons, market-linked returns obtained through exposure on exchange traded derivatives or equity-like components such as warrants or convertibles.

The slowdown in the real estate market, lack of funding for land acquisition, defaulting developers and downgrading of their ratings has led to the sector being highly leveraged. Consequently, developers are now relying on private debt whether as fresh debt or by way of refinancing existing debt. With a high-risk appetite, private equity players have shown interest and invested in the NCDs of such companies. However, owing to the risks involved in such investments such as delay in completion of projects, projects under litigation and general slackening of market demand for real estate, interest rates are substantially higher than other sectors. To insulate themselves from the risk associated with such investments, private debt investors typically collateralise their investment by security cover depending on the developer's credit rating, personal and corporate guarantees. The trend in securing a high return and easy exit is evidenced by way of redemption premiums and default interest being charged on non-completion of predetermined construction milestones.

While private equity players enjoy the many advantages of investing in debt instruments in India, given that NCDs are traded on a wholesale debt market segment, a large part of the deal specifics are to be disclosed to the stock exchanges, where information is publicly available. Further, with new listing norms being applicable across the board, key changes to the structure of the debentures also require approval of the stock exchanges, making changes to bilateral structures subject to regulatory consent.

iii Taxation-related issues

India and Mauritius have recently signed the protocol (Protocol) amending the agreement for avoidance of double taxation between India and Mauritius (DTAA) ushering significant amendments to the DTAA. Pursuant to the Protocol, India has the right to tax capital gains capital arising to a Mauritius entity from the sale of shares of an Indian company acquired on or after 1 April 2017. While transactions where shares have been issued prior to 1 April 2017 would be grandfathered, where convertible instruments have been issued prior to 1 April 2017 but the underlying equity shares are issued post-1 April 2017, capital gains tax could be leviable.

Besides issues emerging from the Protocol, taxation issues in private equity transactions are traditionally centred around withholding tax deductions on payments made to non-residents and issues under Section 281 of the Income Tax Act 1961. Withholding tax issues are settled mostly through a combination of tax indemnity, a certificate from a chartered accountant or a certificate from the Indian taxation authorities indicating the withholding tax or computation. In terms of Section 281 of the Income Tax Act 1961, any transaction involving the creation of charge on an asset by way of sale, for example, while a tax proceeding is pending would be void, as against a claim in such tax proceeding. Almost all the private equity transactions face this issue.

In April, 2017, when the government is expected to notify the General Anti-Avoidance Rules for taxation, all structuring mechanisms would need to factor in the principles laid down therein.

iv Conditional exemption from dividend distribution tax to distributions made by SPVs to REITs

Where assets in a REIT are held by the SPV, dividend distribution tax (DDT) of 20 per cent would be applicable to distributions made by the REIT, making the structure tax-inefficient. With REIT Regulations requiring 90 per cent of the distributable cash flows to be upstreamed, the payments towards DDT would be a recurring leakage. The Finance Act 2016 has proposed to exempt the levy of DDT in respect of distributions from SPVs that are 100 per cent REIT-owed (or co-owned with minimum mandated holding by the co-owner under law) and that such dividend received by the REIT and its investor shall not be taxable in the hands of the trust or investors. While these are welcome steps, given that the exemption is limited to only 100 per cent REIT-owned SPVs, the benefits would not trickle down to joint venture or joint development arrangements, which form a significant part of the sector's assets.

Certain other issues that still require addressing from an industry standpoint include:

a the tax deferral scheme made available to the sponsor on transfer of SPVs shares to the REIT not being extended to the direct transfer of assets and transfer of interest in LLPs; and

b the holding period of REIT units not being brought on a par with other listed securities at one year for availing long-term capital gains benefits.

VI CONCLUSION

The real estate sector is picking itself up from the lows of 2009–10 slowly and steadily. Large platform deals are an indication of the growing investor confidence. With the government's impetus in infrastructure growth and constant attempts at economic liberalisation, the road ahead could be said to be smoother, if not rosy. Key areas to look out for would be the REIT platform and the asset class that goes up for trading. This would be a major push to the public market for real estate assets. India's real estate growth story is far from being fully written.

Chapter 9

INDONESIA

Oene Marseille, Emir Nurmansyah and Gustaaf Reerink[1]

I OVERVIEW OF THE MARKET

To date, Indonesia's market for investment-grade real estate assets is rather illiquid, showing very limited M&A and private equity activity. Many foreign investors consider Indonesia to be a risky place to do business. Indeed, although improving, Indonesia's credit ratings are still below investment grade. Furthermore, the legal framework is generally deemed to be unsupportive of cross-border transactions. Indonesia's investment law and land law impose restrictions on foreign investment. Banking and capital market legislation creates only limited room for creative financial structures. Creditors can establish security rights on land, shares and other assets, but in practice it may not always be easy to enforce these rights.

Being the world's fourth most populous country, with a fast-growing middle class, Indonesia has the potential to develop into a major market for real estate M&A and private equity. An increasing number of foreign investors, particularly from Japan, Korea and China, who already have some experience in doing business in Indonesia, recognise this potential and invest in the country's real estate market. Generally, the ASEAN market has an increased interest among foreign investors. Indonesia, perhaps together with Vietnam, Myanmar and Malaysia, is one of the countries that receives particular attention. Recent pro-foreign investment measures of the Jokowi administration, consisting of, *inter alia*, deregulation measures, a loosening of foreign investment restrictions, and tax and other incentives, contribute to this development.

Some measures that should specifically boost the Indonesian real estate sector are the relaxing by the Indonesian Central Bank (Bank Indonesia) of the macro-prudential policy by raising the loan-to value ratio, or financing-to-value ratio, for property loans. The policy

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should not only benefit individual home owners, but also developers, who can now provide a lower guarantee when taking out a loan from the bank. The Jokowi administration has also relaxed foreign ownership in residential property, albeit with limited short-term benefits expected. Finally, the Minister of Finance and the Indonesian Financial Services Authority (OJK) have taken several measures to make the use of real estate investment funds in the form of a collective investment contract (DIRE) – the Indonesian equivalent of real estate investment trusts (REITs) – more attractive.

There are generally four types of foreign investors active in Indonesia's real estate market:

a public real estate companies;
b DIREs or REITs;
c sovereign wealth funds; and
d private equity.

Foreign investors will need to invest through an Indonesian limited liability company with foreign investment status or with a public listing. There are currently around 60 public real estate companies listed at the Indonesian Stock Exchange (IDX). Many of these companies have foreign participation. Well-known names with a strong presence are Agung Podomoro, Ciputra, Summarecon, Lippo and BSD. Most of the public real estate companies in Indonesia are traditionally developers, but some are trying to diversify their income streams, for instance, by investing in REITs, as discussed in further detail in Section III, *infra*.

Foreign investors generally invest in four categories of real estate in Indonesia:

a commercial buildings for offices, hotels or retail;
b residential buildings;
c hospitals and healthcare;
d land for development.

Most of the investments are for the long term, but particularly the investments in commercial buildings and residential buildings are sometimes only made to support development, after which individual units or parts of the property are sold.

In addition, some foreign conglomerates whose core business is not necessarily real estate are becoming active on Indonesia's real estate market. This also applies to certain financial institutions and insurance companies. These companies are often investing in commercial real estate for their own domestic occupation, for instance, for foreign employees that need to be housed in Indonesia.

In terms of transaction structure, the investments are generally still rather conventional. Most acquisitions consist of plain vanilla sale and purchase of direct property, and sometimes involve the sale and purchase of shares in local real estate companies, either directly or through the IDX. Again, the legal framework puts limitations on the creation of more sophisticated structures. Often, foreign investors create a joint venture with local partners, which indeed may be a requirement under Indonesian investment legislation.

In terms of deal value, the investments may sometimes be significant, but generally not as large as in countries with a more developed real estate market.

II RECENT MARKET ACTIVITY

i M&A transactions

M&A activity on Indonesia's real estate market is limited. A noteworthy transaction was the agreement between GIC Pte, Singapore's sovereign wealth fund, and PT Rajawali Group, a large, privately owned investment company, to jointly invest up to $500 million in property projects in Indonesia in November 2014. The investment focuses on property projects in Jakarta's Central Business District. However, the joint venture will also explore other real estate opportunities, including in office, retail, residential and mix-use projects.[2]

ii Private equity transactions

Private equity activity on Indonesia's real estate market is even more limited. A noteworthy transaction is the creation of a joint venture between subsidiaries of Warburg Pincus LLC and the Indonesian public real estate company PT Nirvana Development Tbk in 2015. PT Nirvana Development specialises in the development of hypermarket anchored retail centres in emerging cities across the country. Since 2009, the company has developed five mixed-use projects in second and third-tier cities across Java and Kalimantan. The company's aim is to development more projects in other cities in Indonesia, including Sumatera, Sulawesi and Nusa Tenggara. As part of the investment, the private equity firm committed $125 million, with the option to invest up to an additional $75 million.[3]

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

As briefly touched upon above, there is currently no legal basis in Indonesia for the establishment of REITs. Instead investors who wish to invest in income-producing real estate in Indonesia can do so through DIREs. Contrary to REITs, DIREs are not legal entities, but are based on contract. DIREs are regulated by the OJK. In April 2016, the OJK issued a new regulation with guidelines for investment managers and custodian banks that manage DIREs. It is currently also preparing a regulation of DIREs based on shariah principles.[4]

A DIRE scheme involves a custodian bank and an investment manager who makes a collective investment in, *inter alia*, real estate and assets that are related to real estate – i.e., securities of real estate companies that are listed on the IDX or issued by real estate companies (or both).

It is not possible for a DIRE to invest in vacant land and real estate that is under development. However, it would be possible for a DIRE to invest in a special purpose

2 See www.gic.com.sg/newsroom?id=482.

3 See www.warburgpincus.com/investments/nirvana-development/; www.warburgpincus.com/category/news-releases/.

4 See www.antaranews.com/berita/552845/ojk-berharap-perusahaan-properti-terbitkan-dire-syariah.

company (in the form of an Indonesian limited liability company), established solely to invest in real estate assets. If a special purpose company is used, the DIRE must own at least 99.9 per cent of the issued shares of the special purpose company.

Unresolved matters include how a DIRE can directly invest in real estate or own shares in a special purpose company, considering that a DIRE is not a legal entity, while under the Indonesian Agrarian Law, only Indonesian individuals and certain legal entities can have title to land in Indonesia, and under the Indonesian Company Law, shares in an Indonesian limited liability company can only be held by legal entities or individuals.

It is prohibited for DIREs to borrow funds by way of issuing debt securities. The 2016 OJK regulation is more lenient regarding the maximum percentage of borrowed funds other than by way of debt securities, which increased from 20 per cent under the old regulation to 45 per cent of the total value of the real estate to be purchased under the new regulation.

There appears to be just one DIRE that is currently active in Indonesia: DIRE Ciptadana Properti Ritel Indonesia, which has been listed on the IDX since 2013. It owns a shopping centre in Solo, Java.

A likely reason for the limited popularity of DIREs is the lack of corporate and financial transparency that these funds and Indonesian companies generally often show. It is unlikely that recent measures aimed at making the use DIREs more attractive will change the general negative sentiment among foreign investors regarding these funds.

Apart from DIREs, some offshore REITs are active on the Indonesian real estate market. Two noteworthy examples are Lippo Malls Indonesian Retail Trust (LMIR Trust) and First REIT, both REITs listed on the Singapore Exchange Securities Trading Limited (SGX), sponsored by the Indonesian public real estate company PT Lippo Karawaci Tbk. LMIR Trust has a diversified portfolio of 17 shopping centres and seven retail spaces across Indonesia.[5] LMIR Trust is currently discussing the acquisition of an additional shopping centre in Kuta, Bali.[6] First REIT has a portfolio of 12 hospitals, two hotels and one shopping centre in various cities in Indonesia, in addition to several assets in Singapore and South Korea.[7] LMIR Trust and First REIT are currently discussing the joint acquisition of an integrated development of hospital and shopping centre assets in Yogyakarta, Java.[8]

ii Real estate PE firms – footprint and structure

As discussed above, private equity activity on Indonesia's real estate market is very limited. In the case of the aforementioned investment by Warburg Pincus LLC, a joint venture was created through an acquisition by Adventure Holdings BV, an affiliate of Warburg Pincus LLC, of 35 per cent of the shares in PT Nirvana Wastu Pratama, a subsidiary of PT Nirvana Development Tbk.[9]

5 See www.lmir-trust.com/.

6 See www.lmir-trust.com/investor.html.

7 See www.first-reit.com/about-overview.html.

8 See www.lmir-trust.com/investor.html.

9 See www.reuters.com/article/indonesia-press-nirvana-dvlpmt-warburg-p-idUSL3N0WR0NL20150325.

IV TRANSACTIONS

i Legal frameworks and deal structures

As discussed above, investments in Indonesia's real estate sector are generally still rather conventional, consisting of plain vanilla sale and purchase of shares in local real estate companies, either directly or indirectly (i.e. through the IDX).

A direct sale and purchase of shares in a local real estate company may be subject to foreign investment restrictions, for example, by imposing a cap on foreign ownership in Indonesian companies. Indonesia's 2007 Investment Law creates authority for the president to compile a list of business lines that are closed and conditionally open to foreign investment. A revised version of this 'Negative List' became effective in May 2016.

A common business line for a real estate company in Indonesia would be '68110 – Real estate that is privately owned or rented'. This business line includes buying, selling, renting and operating of self-owned or leased real estate, such as apartment buildings, dwellings and non-residential buildings. As this business line is not included in the 2016 Negative List, a local real estate company with activities covered by this business line should in principle be 100 per cent open to foreign investment.

If the real estate company is not only active in buying, selling, renting and operating of self-owned or leased real estate, but also other activities (e.g., the construction or operation of real estate), different business lines are relevant, which may be included in the Negative List and can therefore be closed or conditionally open to foreign investment.[10] In any event, from experience, although not explicitly listed as a business field that is closed or a business field that is conditionally open in the Negative List, certain business fields may in reality not be open to foreign investment. Furthermore, an Indonesian limited liability company (PT) should have at least two shareholders, so even if no foreign restrictions apply, it is common to have a local shareholder to hold part of the shares. There may also be commercial reasons to have local participation in the company.

A foreign investor wishing to purchase shares in a local real estate company requires a licence from the Indonesian investment coordinating board (BKPM). If the local real estate company is a 'normal' limited liability company with Indonesian shareholders, 'a principal licence for investment' must be obtained. This licence will result in the conversion of the company into a foreign investment (PMA) company, allowing the foreign investor to become a shareholder. As part of the application process for a principal licence for investment, the investor should submit an investment plan, by which the investor confirms willingness to invest more than 10 billion rupiah per business line, at least 2.5 billion rupiah of which should come in the form of equity. Before the shares in the local real estate company are transferred, it will generally be required to amend the articles of association of the company, for instance, in order to increase the issued and paid-up capital to at least 2.5 billion rupiah (in the case the company has one business line). After the BKPM has issued a principal licence for investment, the company will have to submit quarterly activity reports, which are used by the BKPM to monitor the implementation of the investment plan. As soon as the investment plan has been realised and the company is ready for operation, a business licence can be obtained.

10 See also Section V, *infra*, on foreign investment restrictions to companies active in providing integrated services for the support of facilities as well as cleaning services for buildings.

If the real estate company already has the status of a PMA company, it will still be required to obtain a licence from the BKPM. This licence is a 'principal licence for amendment' or, if the investment plan has already been realised and the company is already operating, a 'business licence for amendment'.

It usually takes around a month to obtain a principal licence for investment and around two weeks to obtain a principal licence for amendment from the BKPM.

No foreign investment restrictions apply to a sale and purchase of shares in a local real estate company through the Indonesian Stock Exchange. The 2016 Negative List stipulates that foreign investments in business fields that are conditionally open but made indirectly or as portfolio investment through the IDX will be deemed to be business fields that are open to foreign investment.

Foreign investment restrictions also do not apply to a venture capital company (PMV); any equity participation by a PMV would be deemed to be domestic investment rather than foreign investment – even if one or more shareholders of the PMV are foreign. A PMV can be established in the form of a limited liability company, cooperative or limited partnership (CV). The minimum capital requirement to establish a PMV in the form of a limited liability company is 50 million rupiah. A PMV in the form of a PT can be 85 per cent owned by a foreign entity or institution. However, the maximum direct capital participation in a PMV by a foreign entity as a shareholder is limited to the maximum amount of such entity's net equity. Business activities in which a PMV may be engaged are equity participation, quasi-equity participation or financing through purchase of securities issued by business partners. Business partners can be individuals or companies, including micro, small, medium businesses and corporations receiving equity participation based on a profit-sharing principle from the PMV, and financing of productive business. A PMV may participate in a real estate company provided that the value of participation in one business partner (in this case, the real estate company) is a maximum 25 per cent of the venture capital company's equity. Furthermore, this participation may only last for 10 years (plus extension for another 10 years). After the lapse of this period, the PMV must divest its shares in the real estate company as the purpose of a PMV is to help start up companies. Parties wishing to establish a PMV must obtain a business licence from the OJK.

It would also be possible for a foreign investor to carry out an asset deal. However, asset deals are not very common in Indonesia, as the transfer of assets in general and land, buildings and fixtures in particular can be a rather complicated, time-consuming and costly process. If a foreign investor decides on an asset deal, it will be necessary to establish a PT first. This company should obtain its own licences to be active in the real estate sector, as licences can generally not be transferred under Indonesian law.

Irrespective of whether it has the status of a normal limited liability company or a foreign investment company, a PT cannot hold an ownership right on land; this right is strictly reserved for individuals with Indonesian nationality. However, a PT can hold three other types of land rights: right of cultivation, right to build and right of use. In practice, the right to build is the type of land right most commonly used by real estate companies. It is granted for a maximum initial period of 30 years and is extendable for another period of 20 years, with a possibility of renewal.

On top of an ownership right, right to build and right of use, a right of ownership to a multi-storey unit can be established. This right can be issued to owners of residential, commercial or retail units in multi-storey buildings such as condominiums, strata-title office buildings or trade centres. The validity period depends on the expiry date of the land right on which the right of ownership to a multi-storey unit has been established.

The ownership right, right to build, right of use, and of ownership to a multi-storey unit can be sold, exchanged, transferred, bequeathed or mortgaged.

ii Acquisition agreements terms

Given the illiquid character of the Indonesian real estate market, it is hard to provide a description of the typical terms of real estate M&A and PE transactions. However, it is common for parties to enter into a share purchase agreement for the acquisition of existing shares or a share subscription agreement for the subscription for new shares in a local real estate company.

Although in-kind contribution is also possible under the law, shares are normally acquired or subscribed for by payment of a cash consideration. The purchase price is often paid directly to the sellers or issuers of the shares (i.e., without the use of an escrow account). Price-adjustment mechanisms are sometimes used, normally in the form of closing accounts, rather than locked-box mechanisms.

Given that foreign investment is strictly regulated in Indonesia, parties in M&A and private equity transactions will normally need to agree on conditions precedent relating to regulatory approvals, in addition to corporate and third-party approvals that need to be obtained. As a result, it may take a relatively long time for a transaction to be closed. For this reason and also given the uncertainties in the market, material adverse change clauses are also commonly used and accepted by parties. Equally, it is common for parties to agree on a broad list of pre-closing covenants. The use of a long stop date for the fulfilment of the conditions precedent is also generally accepted. Break fees are sometimes used, but not very common.

Just like other companies, real estate companies in Indonesia often have compliance issues. For this reason, it is common and in any event advisable to conduct extensive legal, financial and tax due diligence on a target company. Warranties and specific indemnities are commonly agreed on to mitigate at least part of the potential liabilities. To the extent these liabilities cannot be sufficiently mitigated, it may be advisable to do an asset deal, despite the fact that – as discussed above – the transfer of assets can be a rather complicated, time-consuming and costly process.

When foreign investors choose to create a joint venture with local partners for their real estate investment, parties often enter into an additional joint venture agreement or shareholder agreement. These agreements commonly create rights for certain shareholders to, *inter alia*:

a nominate members of the board of directors and board of commissioners of the company;

b list reserved matters at the level of the board of directors, board of commissioners or the general meeting of shareholders;

c set out a deadlock mechanism for when shareholders or their nominated directors or commissioners cannot agree on the reserved matters; and

d contain terms in business plans and reporting, financing of the company, the distribution of dividend, create restrictions on the transfer of shares.

Some of the provisions of the joint venture agreement or shareholders' agreement may also be covered by the articles of association of the company.

iii Hostile transactions

There do not appear to have been any hostile transactions in Indonesia's real estate sector.

iv Financing considerations

M&A and private equity transactions in Indonesia's real estate sector are typically financed by a combination of equity and debt. As discussed above, when a foreign investor wishes to purchase shares in a local real estate company, the company will need to have the status of a foreign investment company. This also implies that more than 10 billion rupiah per business line should be invested; at least 2.5 billion rupiah of this amount should come in the form of equity. If the company has more than one business line, the investment requirement is multiplied by the number of business lines.

Certain reporting requirements apply to a recipient of a foreign loan in Indonesia. Furthermore, when certain monetary thresholds are met, the conversion of Indonesian rupiah to foreign currencies or the purchase of foreign currency against Indonesian rupiah conducted by a bank and its customers must be based on an underlying transaction.

Under Indonesian law, lending obligations can be secured by various types of security. Rights to land as well as buildings and fixtures can be mortgaged. Shares in a PT can be pledged. Security on moveable assets can be established in the form of a 'fiduciary transfer'. Other than in the case of a pledge, the creditor-transferee holding a security in the form of fiduciary transfer will normally not have physical control of the assets.

In order to be able to create security such as the above, generally, consent from existing creditors is needed. In addition to creditor consent, shareholder approval is also required. The Indonesian Company Law and the articles of association of an Indonesian company normally stipulate certain requirements to obtain corporate approval from the organs of the company (i.e., the board of commissioners or the general meeting of shareholders). Lack of corporate approval would legally affect the validity of the loan and pledge agreements and cause the board of directors to be held liable for any loss in relation thereto.

v Tax considerations

The proceeds from a sale of shares in an Indonesian company may be subject to capital gains tax, which, where the shares are not listed, is 25 per cent when the seller is a company and 30 per cent when the seller is an individual. The sale of shares listed on the IDX is subject to a tax of 0.1 per cent of the transaction value.

Dividends received by a resident company from another Indonesian company are exempt from tax, provided the dividends come from retained earnings and the recipient company holds at least 25 per cent of the capital of the company distributing the dividend. If the recipient company holds less than 25 per cent of the shares, the received dividend is subject to 15 per cent withholding tax, which represents an advance payment of the company's tax liability. Dividends distributed to a non-resident are subject to 20 per cent withholding tax, unless the rate is reduced under a tax treaty. Dividend distributions to individual shareholders are subject to 10 per cent withholding tax. Dividend income of individual shareholders is subject to another 10 per cent final income tax.

In order to limit tax exposure, it may be an option to transfer shares at the level of the offshore parent of an Indonesian real estate company, in which case the transfer of shares is not subject to any Indonesia withholding, provided that the parent company is not a tax resident of a tax-haven country.

In the case of an asset deal, the sale of assets is subject to 10 per cent VAT. Furthermore, any capital gain on the sale of assets (non-land or buildings) is subject to a 25 per cent income tax. The transfer of land will trigger the obligation for the seller to pay income tax, which is 5 per cent of the purchase price of the land (unless the seller is foreign and the rate is reduced under a tax treaty), and the purchaser to pay an administrative fee for the transfer of land rights, which is approximately 4.7 per cent of the purchase price of the land.

In 2015, the Minister of Finance enacted a regulation on the tax treatment of taxpayers and taxable entrepreneurs that use certain collective investment schemes for the financial sector. The regulation brings an end to double taxation on DIREs. More particularly, the special purpose vehicle that manages the DIRE will be exempted from the obligation to pay income tax. Furthermore, the special purpose vehicle or the DIRE is considered as a low-risk tax entrepreneur and can therefore benefit from an expedited tax refund.

Land and building tax is payable each year on land, buildings and fixtures. The rate is determined by the regional governments and therefore depending on where the assets are located. However, the rate is typically no more than 0.3 per cent of the estimated value of the assets.

vi Cross-border complications and solutions

As discussed above, a direct sale and purchase of shares in a local real estate company may be subject to foreign investment restrictions. In order to circumvent foreign investment restrictions, foreign investors sometimes resort to an investment structure involving nominee arrangements, on the basis of which an Indonesian individual or entity holds the shares on behalf of the foreign shareholder. However, in Article 33 of the 2007 Investment Law, an express prohibition was introduced so that 'the foreign investor and the domestic investor who invest in a limited liability company to enter into agreements and/or statements which assert that share ownership in such limited liability company is for and on behalf of another person'. Such agreements are invalid and unenforceable. Article 33 of the Investment Law also provides for these agreements to be null and void.

In practice there continues to be still much uncertainty as regards the correct interpretation of the nominee prohibition. However, any element of the contractual arrangements that goes beyond a true financing arrangement runs the risk of running foul of the law. This means that in very broad terms these arrangements should best avoid powers of attorney to exercise ownership rights and of assignment of dividends and voting rights. However, a true financing arrangement (which could be strengthened and secured by a right of pledge) should be allowed under the law. Under Indonesian company law, the voting rights on shares must remain with the pledgor.

V CORPORATE REAL ESTATE

There does not appear to be any trend in the Indonesian real estate market in separating corporate real estate from operating companies.

It is common in Indonesia to separate the ownership of real estate from building management. Building management activities could, for example, be covered by the following business lines: '81100 – Integrated services for the support of facilities, such as general interior cleaning, maintenance, waste disposal, guard and security, mail routing, reception, laundry and related services'; '81290 – Cleaning services for buildings'; and '81300 – Services for garden maintenance'.

Note that activities under business lines 81100 and 81300 may be, and 81290 are, closed to foreign investment.

VI OUTLOOK

The prospects of Indonesia's real estate market are rather positive. Momentum is picking up. The effects of recent and ongoing pro-foreign investment measures of the Jokowi administration are already visible and will likely become stronger in the longer term. Having said that, Indonesia's credit ratings as well as its legal framework will likely need to improve further before the country's market for investment-grade real estate assets can gain full potential.

Chapter 10

IRELAND

Paul Robinson, Ailish Finnerty and Sophie Frederix[1]

I OVERVIEW OF THE MARKET

In recent years, there has been a welcome return to activity in the Irish M&A and real estate markets. At the end of 2013, Ireland exited the external assistance programme from the EU, the European Central Bank and the International Monetary Fund. Overseas investors and private equity groups have ramped up investment in Irish real estate amid confidence that the economy has stabilised and returned to growth. Commercial real estate in the Dublin area has been their prime focus.

While real estate investment trusts (REITs) have been a feature of international property markets for many years, Irish legislation allowing the establishment of REITs was only enacted in 2013. Three REITs are currently in operation under the Irish regime: Green REIT plc, Hibernia REIT plc and Irish Residential Properties REIT plc (IRES REIT). Green REIT and Hibernia REIT both launched in 2013. Green REIT raised €310 million on its admission to listing in July 2013 and approximately €400 million following a secondary offering in May 2014. Hibernia REIT launched in December 2013 raising €365 million, while IRES REIT, a subsidiary of Toronto-based Canadian Apartment Properties REIT, secured €130 million debt funding in addition to €200 million raised from its IPO in April 2014.

Irish REITs are predominantly held by international investors. Against this background, it is unsurprising that more than a quarter of all Dublin prime office space has changed hands in little more than three years since June 2013[2] (the proportion of space traded in the central business district was even higher at 38 per cent) with international investors accounting for 68 per cent of sales in the first three months of 2016. Institutional investors and listed REITs have become the biggest buyers of prime office space since

1 Paul Robinson and Ailish Finnerty are partners, and Sophie Frederix is an associate at Arthur Cox.

2 Savills Research – Ireland office – June 2016.

the start of 2015, accounting for 41 per cent of purchases by volume and 80 per cent by value. It appears that overseas funds continue to monitor the Irish market because of the perception that, with yields close to 7 per cent for prime office space, Dublin still offers real value. Post-recession Ireland has unquestionably provided significant opportunities for REITs. A host of multinational technology and life sciences companies (Google, Facebook, LinkedIn, Pfizer, etc.) have substantial operations in Ireland and require prime office and commercial space. Ireland is currently the sixth fastest-growing property market in the world with a price increase of 7.74 per cent in the year to March 2016.[3]

Ireland has also recently introduced a new investment vehicle (in 2015) in the regulated fund space: the Irish collective asset management vehicle (ICAV). The ICAV is specifically tailored to the needs of the global funds industry and unlike its predecessors it can 'check the box' for US tax purposes. Since its creation, because of its particular characteristics, it has become the vehicle of choice for international property investors making direct investments into Irish real estate.

In 2014, a trend emerged whereby private equity groups began selling Dublin office buildings, acquired for low prices during the early part of the recession. This resulted in institutional investors and REITs raising capital and intensifying their acquisitions. The intensification is also the result of deleveraging by Irish banks and a number of foreign banks operating in Ireland including Lloyds, RBS/Ulster Bank, Bank of Scotland and pursuant to the liquidation of Irish Bank Resolution Corporation Limited (formerly Anglo Irish Bank plc before it was nationalised) (IBRC).

The National Asset Management Agency (NAMA) (the state 'bad bank') is a statutory body established in 2009 in response to the financial crisis and the deflation in Irish property prices. NAMA acquired most large property-related loans from Irish banks and initially acquired €77 billion-worth of loans along with the security over the (principally) real estate assets. The establishment of NAMA has been the catalyst for the large volume of property transfers that have taken place in the past few years and it has sold high-end property and property-related loans to private equity funds including Kennedy Wilson (now one of the biggest owners of commercial property in Ireland), Starwood, Davidson Kempner, Lone Star, Apollo and Blackstone. The Irish banks have now largely completed their deleveraging processes.

A more recent development in the market has involved the sale of underlying property-related businesses acquired through debt enforcement including:

a the sale of the Topaz Group (the largest filling station company in Ireland), which was acquired through a purchase of related secured debt in 2013, to Canadian retail giant Alimentation Couche-Tard for a price speculated to be in excess of €450 million; and

b the sale of Arnotts department store to Selfridges Group, which acquired the debt relating to the business from Apollo and NAMA.

Following on from the flurry of secured loan portfolio and property acquisitions, certain investors have recently signalled their intention to focus on asset management and development after years of rolling up assets. Others are in sales mode and assets that were acquired by private equity firms from receivers and loan book sales continue to come onstream. It is a very busy time for Irish property lawyers.

3 *Global Property Guide*, 4 January 2016.

II RECENT MARKET ACTIVITY

i M&A transactions

Since the recession began in 2008, there have been no large-scale pure M&A property transactions, such as had been a feature of 'Celtic Tiger' Ireland. In the past, M&A real estate transactions were driven by a significant 5 per cent differential between the rates of stamp duty (i.e., transfer tax) on commercial real estate and stamp duty on shares (6 per cent real estate versus 1 per cent shares) resulting in certain large real estate transactions being structured as share deals. This differential has now closed to 1 per cent. Transactions of note include the following:

a Becbay Limited in 2008, a company that owned a large site in South Dublin with development potential (the Irish Glass Bottle site), was sold for €412 million.

b Listed company Jurys Doyle Hotel Group plc was acquired in a public takeover in 2005 valuing the company at €1.25 billion. Subsequent to the acquisition, various large real estate assets were disposed of by the privately held company.

c Following on from an unsuccessful management buyout proposal, which put the company in play, Irish Continental Group plc (a ferry operator with large city centre port property with possible development potential) became the subject of a protracted high-profile public takeover battle in 2007 with one of Ireland's then-largest property developers taking a 29.3 per cent position in the public company. In the end, the competing bidders, who held large stakes in the company, did not reach a deal and no takeover took place.

Recent deals completed by REITs and Irish public companies include the following:

a In October 2015, UK-listed property company Hammerson acquired a portfolio of loans from NAMA for a reported €1.85 billion. The loans were connected with Chartered Land, an Irish privately owned property development company, and included the Dundrum Town Centre, Ireland's largest shopping centre. The loans were acquired through a 50:50 joint venture with Allianz. In July 2016, a consensual agreement was reached with Chartered Land to take control of the underlying assets.[4]

b In early 2014, Green REIT and then-joint venture partner Kennedy Wilson (PIMCO) bought 50 per cent of a large development at Central Park in Dublin for €310 million. The development comprised five substantial office blocks, a retail building and a multi-family complex with 272 apartments. The complex was previously owned by Treasury Holdings, a former high-profile Irish private property development company that became insolvent and was wound up in October 2012 after coming under the control of NAMA. In November 2015, Green REIT acquired its joint venture partner's (Kennedy Wilson) 50 per cent interest in Central Park for €155 million. In June 2014, Green REIT acquired a property portfolio from Cosgrave Property Group for €375 million. The company's portfolio comprises 23 properties, 95 per cent of which are located in Dublin, and is valued at €1.2 billion.

4 www.irishtimes.com/business/commercial-property/hammerson-becomes-major-player-with-dundrum-deal-1.2715635.

ii Private equity transactions

Blackstone is reported to have entered into an agreement to buy the Blanchardstown Shopping Centre in Dublin in June 2016 for €950 million, which is expected to complete when antitrust approval comes through. The seller is Green Property, one of the few listed Irish real estate companies before it was taken private in 2002. It remains privately held. Blackstone had previously acquired the well-known Burlington Hotel in Dublin for a reported €67 million in 2012.[5] The Burlington Hotel was subsequently rebranded 'Doubletree by Hilton' and is reportedly on the market guiding at €180 million.[6]

In 2015, Lone Star acquired Jurys Inns Group Limited, the Ireland-based owner and operator of a hotel chain, from a consortium of private equity firms for a total purchase price of €910 million. Jurys Inn operates hotels in Ireland, the United Kingdom and one in the Czech Republic. Lone Star has been very active in the Irish market in recent years, acquiring €540 million-worth of sub-prime mortgages from Start Mortgages and IBRC's UK loan book for €4.7 billion.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

REITs were only introduced in 2013 and all three Irish REITs in operation are listed companies. The Irish Stock Exchange (ISE) has created a listing regime for REITs and has aligned the new requirements with those of the FCA Listing Rules in the United Kingdom to facilitate REITs that may seek a dual listing in Ireland and the United Kingdom. With a choice of adopting IFRS, US GAAP or Irish GAAP for financial reporting, the Irish statutory regime is sufficiently agile to integrate with the majority of global organisations.

Green REIT's portfolio mainly comprises commercial real estate. Green REIT purchased commercial property during the recession when banks were in the process of deleveraging and is now focusing on delivering value for shareholders through 'opportunistic investment, active property management and prudent use of debt finance'.

Hibernia REIT's portfolio mainly comprises Irish residential and commercial real estate assets and its portfolio was valued at €928 million in March 2016. Hibernia REIT's primary focus is on the office sector, but it also acquires industrial, warehousing and distribution, recreational, retail, residential and other Irish property assets.

IRES REIT maintains a mainly residential portfolio, and it is currently one of the largest private landlords in Ireland. The firm purchased loan portfolios from NAMA and others in 2014 and 2015. It has a current portfolio of over 2,000 apartments and net assets of €435 million as at 31 December 2015.

Cairn Homes plc, the Irish property development company, was floated on the London Stock Exchange in March 2015, raising approximately €440 million from investors in Ireland, the United States, the United Kingdom and other jurisdictions. Cairn was the first Irish property developer to float on the stock exchange since McInerney Holdings plc in 1997 (which delisted in 2010). Cairn focuses on acquiring greenfield or brownfield sites

5 The property was purchased in 2007 for €288 million, which shows the extent of the collapse in property values in the recession.

6 *Irish Times*, 27 May 2016.

in Ireland that are suitable for residential development, with an emphasis on Dublin and the Dublin commuter belt, as well as other urban centres. Cairn properties include Cherrywood, a retail-led, mixed-use town and over 3,800 apartments and houses.

REOCs are not a recognised concept in Ireland, and as such there is no specific advantageous tax regime in place as there is with REITs. Given the success of Irish REITs, which are predominantly held by international investors, and the popularity of the REOC internationally, the agile Irish financial and tax system may adapt to bring the concept to Ireland.

ii Real estate PE firms – footprint and structure

International private equity groups have invested heavily in Irish real estate in recent years. During the recession, large transactions were primarily structured as acquisitions of loans secured by underlying real estate assets. Apart from loan book acquisitions, private equity houses have also directly acquired and developed trophy assets including Blackstone's acquisition of the Burlington Hotel in 2012, and their acquisition of Blanchardstown Shopping Centre for around €950 million in June 2016 (subject to regulatory approval).[7]

Key private equity players in the Irish market include Blackstone (details of its activity are set out above), Kennedy Wilson and Apollo. Kennedy Wilson acquired Bank of Ireland's real estate management business in 2011 and has become one of the largest property players in Dublin. It has 105 commercial and 128 privately rented sector leases in Dublin, and saw double-digit rental growth in Ireland in 2015, with full-year income coming in at €29 million. Kennedy Wilson's Irish portfolio includes high-end hotels such as the Shelbourne Hotel, Portmarnock Hotel and Golf Links, shopping centres and prime office space. Apollo acquired loans secured on the Arnotts department store in Dublin following a lengthy bidding process. The loans, which had a face value of €230 million, were bought from the liquidators of IBRC. Apollo subsequently sold its interest in Arnotts to Selfridges.

In completing acquisitions, an Irish regulated fund is frequently used as the acquisition vehicle. This is now typically an ICAV or another variant of a qualified investor alternative investment fund (QIAIF), which generally holds the real estate asset directly or, in certain cases, through a wholly owned limited liability nominee company.

IV TRANSACTIONS

i Legal frameworks and deal structures

Private companies

In a private property sale, there is no codified system of protections afforded to a prospective buyer nor a codified set of obligations imposed on a seller. Instead, the common law principle of caveat emptor applies, and the buyer must build protections into the acquisition agreement. While authorisations from regulatory bodies are required in certain sectors, including banking, insurance, financial services and telecommunications, there are no restrictions on

7 *Irish Independent*, 18 June 2016.

the foreign ownership of real estate or shares in companies owning real estate. Government policy encourages foreign investment and the applicable tax regime can be favourable depending on the structure used.

The primary means used to acquire real estate in Ireland is under private contract, by way of a direct purchase of specified assets (asset purchase) or purchase of the issued shares of a property owning company (share purchase). Consistent with international practice, the advantage of purchasing a company by buying its shares is that the buyer steps into the shoes of the seller as shareholder of the property-owning company and the company continues in its existing form. There is also a stamp duty saving of 1 per cent in buying shares rather than commercial real estate assets. A private share purchase would not be regulated by the the Irish Takeover Rules 2013 (the Rules, considered in detail below), giving the parties more freedom to agree the timetable of the transaction and to include and rely on conditions to completion. An asset purchase can be more advantageous in circumstances where the buyer is interested in a small number of (or specific) assets (e.g., a property) or where there are sizeable or unquantifiable liabilities in a company that would be acquired in a share purchase. A buyer can cherry-pick the assets while avoiding unquantifiable or unknown liabilities.

REITs and public companies

In light of their recent introduction in the Irish market in 2013, there has been no public takeover or spin-off of an Irish REIT to date. One must go back to 2002 to the takeover (by way of management buyout) of Green Property plc for a public takeover of an Irish-listed (pure) real estate company.

A potential takeover of a REIT with shares admitted to listing on the Official List of the ISE[8] would typically take the form of a public offer, which will be regulated by the provisions of, *inter alia*, the Irish Takeover Panel Act 1997 (as amended), the Rules and the European Communities (Takeover Bids (Directive 2004/25/EC)) Regulations 2006 (the Regulations). The Irish Takeover Panel (the Panel) would monitor and supervise a takeover bid.

Court-sanctioned schemes of arrangement (which have become more prevalent in recent years, particularly in the area of re-domestications) can also be used to obtain control of a publicly listed company. The main advantage of a scheme over a public takeover is that the bidder acquires 100 per cent of the target through a cancellation of all of the shares owned by the target's existing shareholders and the issue of new shares to the bidder in their place. The reserve created by the cancellation is capitalised and applied in paying up new shares in the target to the bidder. Using a scheme will usually confer a stamp duty advantage (no stamp duty of 1 per cent is payable), but a scheme is less flexible than an offer and typically takes longer than an offer to implement (largely because three separate court hearings are required).

On a takeover, the duties and responsibilities imposed by Irish law on a REIT's board of directors are similar to those of directors of an Irish-listed company. Any successful takeover offer would likely have to be recommended by a REIT's board of directors (although

8 The shares of the REIT must be listed on the main market of a recognised stock exchange in a member state of the EU. QIAIFs may seek to list their shares on a recognised stock exchange but are not obliged to do so. REITs must be listed on the main equity market whereas QIAIFs will list as investment funds.

similarly to any other listed company, a hostile takeover is theoretically possible). When considering or recommending an offer or scheme, the directors must observe their fiduciary duties to the company, must act *bona fide* in the best interests of the company and not have regard to their personal interests.

Mandatory offer

Under the Rules, a bidder is required to make a mandatory offer, which must be for cash or include a full cash alternative, for the remaining securities in a target if:

a it (or any person acting in concert with it) acquires a holding of 30 per cent or more of the voting rights of the target;

b its holding (or holding combined with any persons deemed to be acting in concert with it) of less than 30 per cent of the voting rights increases to 30 per cent or more; or

c its holding (or holding combined with any persons deemed to be acting in concert with it) of between 30 per cent and 50 per cent of the voting rights increases by more than 0.05 per cent of the aggregate percentage voting rights in that company in any 12-month period.

Squeeze out or sell out

The bidder can compulsorily acquire the shares of minority shareholders under the Regulations and must receive a level of 90 per cent acceptances in value and voting rights of the shares subject to a takeover bid. If the Regulations do not apply to the target company, the Irish Companies Act 2014 (2014 Act) contains a procedure to compulsorily acquire the shares of minority shareholders, which necessitates a level of 80 per cent of acceptances. The Regulations also provide for rights of 'sell out' for shareholders. The main condition to be satisfied to enable the exercise of sell-out rights is that the bidder has acquired, or unconditionally contracted to acquire, securities that amount to 90 per cent in value and voting rights attaching to the securities affected.

Stakebuilding

Under the Transparency Rules issued by the Central Bank of Ireland (CBI), every time a bidder for a publicly listed company reaches or passes through a whole percentage integer from 3 per cent to 100 per cent, a notification to the target and the CBI (via the ISE) must be made within two trading days and the target must itself notify the markets by the end of the next trading day. Additional legal constraints to stakebuilding are set out in the 2014 Act and the Substantial Acquisition Rules 2007 (SARs), which restrict the speed with which a person may increase a holding of voting securities between 15 per cent and 30 per cent. The SARs also apply where persons are acting in concert.

Other typical deal structures

ICAVs

The ICAV is a bespoke corporate collective investment vehicle used in regulated fund structures and it has been the preferred form of collective investment undertaking for large property acquisitions since it was introduced in 2015. ICAVs have two clear advantages over certain other property holding structures. From a corporate perspective, ICAVs avoid the need for compliance with certain Irish company law requirements,[9] resulting in reduced administrative obligations and costs. However, as they are regulated by the Central Bank of Ireland, there are higher establishment expenses and ongoing regulatory costs. From a tax perspective, ICAVs have the advantage of being able to elect in their classification, under the US 'check-the-box' taxation rules, to be treated as transparent entities for US federal income tax purposes. This may give rise to advantageous tax treatment for US investors in certain circumstances.

Limited partnerships

Another type of structure being used regularly for substantial property deals is the limited partnership (LP). An LP is established pursuant to the Limited Partnerships Act 1907 and must consist of at least one general partner and one limited partner. The general partner (GP) of the LP, who manages the LP's business, has unlimited liability (although the GP may be a limited liability company, effectively limiting the liability of the LP). An LP is transparent from an accounting and taxation perspective and is not subject to Irish company law. There are also fewer public filing requirements for an LP than a company. The use of LPs, as a component part of a tax-efficient structure for holding Irish real estate has increased recently. It would be highly unusual to use an LP in a public offer.

ii Acquisition agreement terms

In Ireland, loan portfolio sales (secured by real estate assets) are nearly all conducted as private contract auction sales. Guarantees, deposits, equity commitment letters or net asset value covenants are typically required by sellers in loan portfolio sales. Terms are extremely seller-friendly, with limited title and capacity warranties (and none in relation to enforceability of security), low caps on liability compared with market practice in typical M&A private company transactions (e.g., 10 per cent of overall consideration) and other extensive limitations on liability. However, pricing also reflects the fact that, on the basis of the overall acquisition framework, there is a very remote chance of being able to bring a successful warranty claim. The use of warranty and indemnity insurance and title insurance is increasingly used to bridge the risks sellers refuse to cover commercially.

Type of consideration

The principal form of consideration in real estate transactions in Ireland is a deposit on signing with a single cash payment on completion. Shares, loan notes, warrants, promissory notes or any combination of these may be offered as consideration, but it is uncommon.

As noted above in relation to public companies, in the case of a mandatory offer or where a bidder acquires any shares in the target company for cash during the offer period, the Rules require that the consideration is cash or a cash equivalent. Where cash is being offered, the legal requirement for a cash confirmation means that the financing must be in place at the time of the Rule 2.5 announcement (an announcement of a formal intention to make an offer) in respect of a target to which the Rules apply.

9 For example, it will not be necessary for the ICAV to produce consolidated accounts and the ICAV may dispense with the ability to hold an annual general meeting by giving at least 60 days' written notice to all ICAV shareholders.

Representations, warranties and indemnification

In common with practice in most common law jurisdictions, a private property acquisition agreement can, and would typically, include certain buyer protections, such as warranties and indemnities. Liability is usually resisted by the seller for information made available (possibly to a number of potential suitors) at the due diligence stage. In a real estate acquisition via shares, disclosures are made in a disclosure letter and a seller's liability is usually limited to the extent of matters fairly disclosed in or by the disclosure letter. Indemnities may be negotiated in circumstances where specific issues of concern are discovered during diligence (but indemnity protection is the exception rather than the rule).

Closing conditions

Common conditions to closing include antitrust or regulatory approval, shareholder approval (in public deals) and availability of financing (only in private deals). The Competition and Consumer Protection Commission (CCPC) is the antitrust regulatory body in Ireland. Subject to certain financial thresholds, a bidder proposing to acquire direct or indirect control of a company with a trading business must provide advance notice to the CCPC and get its approval. Any transaction that requires CCPC approval will be void if put into effect before the approval of the CCPC is obtained. Recent changes in Irish antitrust law have resulted in many individual hotel acquisitions (as they are trading businesses) requiring CCPC approval.

iii Hostile transactions

Hostile transactions rarely occur in Ireland and none have ever successfully been executed in relation to a real estate listed company. A public takeover can either be by way of public offer or a scheme of arrangement. A hostile bid is highly unlikely to be structured as a scheme (as a scheme typically requires the cooperation of the target). Typically, the announcement of an offer would be a joint announcement and the target would provide important input into the announcement, which needs to comply with the Rules. Because of the nature of real estate assets, the asymmetry of information between the hostile bidder and the resisting target in its response document would present something of a challenge for any hostile bidder.

iv Financing considerations

Transactions are typically structured with a combination of equity and senior bank debt. However, in order that the financing requirements do not jeopardise a deal, private equity firms often acquire either the assets or the loan portfolios from their own cash reserves and seek to put in place bank financing afterwards. As business confidence has returned to the Irish market, more Irish companies appear to be accessing the equity capital markets (both in Ireland and overseas) to facilitate acquisitions.

v Tax considerations

REITs and QIAIFs (including ICAVs) benefit from special tax treatment in Ireland, both in relation to the direct taxation of the vehicle itself and in relation to the taxation of the shareholders in those vehicles.

A REIT is exempt from Irish corporation tax on income and gains arising from its property rental business (subject to certain clawback rules). Investors in a REIT are subject to Irish tax on distributions from the REIT and a REIT is required to distribute 85 per cent of its property income annually. In the case of non-Irish investors, income distributions from the REIT are subject to 20 per cent dividend withholding tax, which must be withheld by the REIT regardless of whether the investor is resident in a double tax treaty jurisdiction. This differs from the position, for example, in respect of treaty-resident investors in normal Irish-resident companies, where various dividend withholding tax exemptions are available. This is essentially the trade-off for the REIT's tax-exempt status on property rental income. Certain non-residents may be entitled to recover some of the tax withheld on distributions from the REIT under the provisions of a double tax treaty or otherwise should be able to claim credit against taxes in their home jurisdictions. Exemptions from withholding tax will apply for distributions to pension funds, insurance companies and certain investment undertakings.

Irish QIAIFs (including ICAVs) are exempt from Irish tax on income and gains regardless of where their investors are resident. In addition, provided that they have made the necessary declaration of non-residence in Ireland, no withholding or exit taxes apply on income distributions or redemption payments made by an Irish QIAIF or ICAV to non-Irish resident investors. Accordingly, Irish QIAIFs are considered to be a highly tax-efficient vehicle for non-Irish resident investors to invest in Irish real estate. As previously noted, ICAVs have the added tax advantage of an election to 'check the box' such that the ICAV would be treated as a 'partnership' or 'disregarded entity' for US tax purposes, potentially saving tax for US investors.

Unless Irish-resident shareholders are exempt (e.g., by virtue of being a pension scheme, life assurance company or certain other specified person), the QIAIF is obliged to deduct tax at the rate of 41 per cent (25 per cent for corporate investors) from any distributions made to such shareholders and remit the tax to the Revenue Commissioners. Tax must also be deducted by the QIAIF from any gain arising on an encashment, repurchase, cancellation or other disposal of shares by a non-exempt Irish-resident shareholder at the rate of 41 per cent (25 per cent for corporate investors). Any gain will be computed as the difference between the value of the shareholder's investment in the QIAIF or ICAV at the date of the chargeable event and the original cost of the investment.

There is also an eight-year deemed disposal rule that applies where the total value of shares in a QIAIF, held by non-exempt Irish resident shareholders, is 10 per cent or more of the net asset value of the fund.

LPs are transparent for tax purposes, meaning that no tax will be chargeable at the LP level. Instead, the investors are subject to tax directly. As noted above, LPs must have at least one general partner and one limited partner. Such partners could include companies, individuals or corporate vehicles with special tax treatment as described above.

An Irish-resident company is subject to Irish corporation tax at 25 per cent on rental income.[10] In addition, in the case of a closely held Irish-resident company, a 20 per cent surcharge applies in respect of rental income held by the company that is not distributed within 18 months of the end of the accounting period in which the income arises. In contrast, non-Irish resident companies are subject to Irish income tax at 20 per cent on Irish rental

10 Various deductions are available in computing taxable rental income, including interest on borrowings to purchase or develop Irish property, although deductible interest on borrowings in respect of residential property is restricted to 75 per cent of the interest.

income and the close company surcharge on undistributed rental income does not apply. For individual investors, rental income derived from Irish property is subject to Irish income tax at marginal rates (20 per cent or 40 per cent depending on the level of income).[11]

Stamp duty and VAT are considerations for any acquisition of property, regardless of the property holding structure used or the tax residence of the investor. Stamp duty applies at the rate of 1 per cent on a share sale and at the rate of 2 per cent on an asset sale. VAT is not chargeable on a share sales but may be chargeable on asset sales depending on the circumstances and the nature of the property. Any such VAT may be recoverable by the buyer depending on its VAT status and the use to which it is applying the real estate.[12] However, the purchase of an undertaking or business that is capable of being operated on an independent basis should qualify for transfer of business relief, eliminating any VAT charge.

Sales of Irish property generally give rise to capital gains tax (CGT) at the rate of 33 per cent on any gain realised, irrespective of the tax residence of the person making the disposal. CGT also applies to share sales where more than 50 per cent of the value of the shares is derived from Irish land. As previously mentioned, such a CGT charge should not arise for disposals from REITs or QIAIFs.

vi Cross-border complications and solutions

There are no Irish constraints on foreign acquisitions of Irish property or shares in an Irish property holding company.

V CORPORATE REAL ESTATE

The global recession resulted in propcos owning devalued assets, which breached the terms of their loan-to-value covenants, while the ability to service their debt from the opco income stream became fragile as opcos struggled to meet their rent payments. Nevertheless, to date, there appear to have been no separate opco/propco structures implemented in Ireland at the REIT or other large corporate level. However, such structures are now typically implemented at individual asset level, primarily in the hotel sector but also in industries that have valuable property assets used in a trading capacity.

11 They may also be liable for pay-related social insurance (PRSI) and universal social charge, although exemptions may apply in the case of non-Irish resident individuals.

12 VAT on property is a complex area and the VAT position will vary depending on the nature of the property (residential or non-residential property, freehold or leasehold), whether developed or undeveloped, when it was acquired or developed, whether VAT was recovered on its acquisition or development and other factors.

VI OUTLOOK

The Irish economy is growing at one of the fastest rates in the eurozone – GDP increased by 26.3 per cent in 2015 according to latest Central Statistics Office figures.[13] Notwithstanding this anomaly, the IMF estimates Ireland's GDP will grow at 3.2 per cent in 2017 (reduced from 3.6 per cent due to Brexit). Consumer sentiment is at a 10-year high, unemployment levels continue to fall, access to capital remains buoyant and exchequer returns are exceeding expectations. A weak euro also enhances the attractiveness of Irish assets. These factors positively influence demand and ability to execute transactions in the Irish market.

One key factor of concern is that on 23 June 2016, UK voters opted to leave the EU. Clarity on the eventual form of the relationship between the United Kingdom and Ireland and the United Kingdom and the EU will take a number of years to appear. In the meantime, it is clear that some inbound real estate investors might choose to delay investment decisions until there is more clarity on how the Irish economy, which is intrinsically linked to the UK economy – our largest trading partner – will be affected. The next 24 months are likely to be volatile, but present opportunities. In particular, as a result of Brexit, with many UK multi billion-pound commercial property funds (for example, Aviva, M&G and Standard Life) halting trading and barring investors from withdrawing their cash, many opportunities could arise for the well-capitalised Irish REITs. Separately, multinationals considering locating their European headquarters in the United Kingdom may decide to switch to Ireland, which, if Brexit is actually implemented, will be the only English-speaking member of the EU.

13 This is not a typographical error, however, the 'normalised' rate for 2015 would be much lower. The 26.3 per cent rate appears to have been mainly caused by large companies moving assets to Ireland that were previously held in other jurisdictions. The overall 2016 rate is likely to be single-digit.

Chapter 11

ITALY

Alessandro Balp[1]

I OVERVIEW OF THE MARKET

i Recent trends in the Italian real estate market

The Italian real estate market experienced a period of growth from the early 2000s until 2008. Growth was driven by widespread market confidence, easy access to credit, and positive, albeit limited, economic growth. Growth was accompanied by positive signs in the real estate market and, in particular, by sustained average annual absorption and a very low availability rate.

During this period, international investors and international private equity funds started to consolidate their presence on the Italian real estate market, often co-investing with Italy-based local investors.

Since 2000, thanks to the introduction of new legislation facilitating the set-up of real estate investment funds and affording them a favourable tax treatment, the real estate fund sector started to gain prominence, with the listing of several publicly traded real estate funds and the establishment of dozens of funds reserved to qualified investors (often used by international investors to invest in the Italian market).

This boom period also saw the launch of significant property development and major urban renovation projects, supported by easy access to relatively cheap financing. In addition to the traditional investments in the office and retail sectors, investors started to venture in the logistics, hotel and leisure sectors.

Transaction volumes grew significantly and reached historical peaks in 2006 and 2007 (respectively €8 and €9.5 billion).

The market began to change radically in the second half of 2007. Investment volumes fell sharply, Italian-based investors started to experience severe financial difficulties, and international investors began to shun the Italian market. Two years of severe economic recession in 2008 and 2009 were followed by a phase of protracted and significant contraction of corporate real estate investments, with volumes falling from €6.8 billion in

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2008, to €4.3 billion in 2011 and €2.9 billion in 2012. Due to the deteriorating economic and financial environment in Europe, investment volumes substantially returned to the level of 2003–2004.

Since the second half of 2013, however, the Italian real estate market has witnessed significant signs of recovery, both in terms of market attractiveness and investments volumes. In 2013, investment volumes rose to €4.7 billion, from the bottom levels of €2.9 billion of 2012, increasing again to €5.3 billion in 2014 and reaching €8.2 billion in 2015.

2015 witnessed a sharp increase in the real estate activity compared with previous years, with significant growth in volumes and in the overall number of sizeable transactions.

The main driving force behind this turnaround has been the impressive comeback of foreign investors, who have significantly increased their presence in Italy and are showing interest for investments beyond the traditional office and retail sectors.

In 2015, foreign investors (mainly international property funds, sovereign wealth funds, insurance companies and family offices) accounted for over 80 per cent of the institutional real estate market – a percentage not seen since 2007.

2015 saw investments being concentrating in the more liquid markets of Milan and Rome, with Milan attracting some €4.5 billion of the total investments made in Italy flowed in 2015.

The strong competition for core assets in prime locations has led to a decrease in prime yields. Investors are now gradually moving up in the risk scale, looking at more opportunistic investments or secondary locations, and showing growing appetite for higher-risk transactions (value added transactions and developments).

The credit market has not yet fully recovered – another factor giving an edge to foreign investors, who have easier access to international finance markets, over domestic players.

ii Main players in the Italian real estate market

The Italian real estate market is mainly a private market, with the main players being Italian real estate funds, international private equity and property funds, institutional investors, sovereign wealth funds and other private investors.

Listed REITS and listed property companies are not a significant component of the Italian real estate market. At June 2016, Italy had only four listed REITS,[2] fewer than their European peers, with an aggregate market capitalisation of €2,5 billion. By way of comparison, the United Kingdom has 33 listed REITS, France has 20 and Spain has 10.

Since 2013, foreign investors have been the main players in the market and, as shown in the following table, now represent the main source of investment capital in the Italian real estate market.[3]

Corporate investment in Italy by investor's origin (% of total)		
Year	*Italian*	*Foreign*
2008	55	45
2009	79	21
2010	73	27

2 Beni Stabili, IGD, Aedes and Coima.

3 Source: Nomisma, *Second Report on the Real Estate Market* 2015, July 2015.

Corporate investment in Italy by investor's origin (% of total)		
Year	*Italian*	*Foreign*
2011	82	18
2012	74	26
2013	31	69
2014	23	77
2015 (Q1)	10	90

The most active foreign investors in the Italian market include Blackstone, Cerberus, Morgan Stanley, AXA Real Estate, Allianz and the Qatar sovereign fund.

In addition to foreign investors, Italian asset management companies (SGRs) managing real estate investment funds continue to play a major role in the market, with a growing trend towards market consolidation. The recent business combination of Investire Immobiliare SGR, Beni Stabili SGR and Polaris SGR led to the creation of the second-largest real estate asset manager with over 30 funds and total assets under management (AUM) in excess of €7 billion. The top five assets managers now manage over 50 per cent of total assets under management, with the top 10 representing over 70 per cent of the total. The largest real estate asset managers present in Italy by AUM are IDeA Fimit, Investire, BNP Paribas Reim, Generali Immobiliari and Coima.

II RECENT MARKET ACTIVITY

The largest and most visible transactions carried out on the Italian market reflect the trend described in the previous paragraph. Purchasers have been mainly foreign investors, and public M&A and capital market transactions have been very limited. Private equity funds have continued to play an important role on the market.

i Major transactions – first half 2016

The first six months of 2016 have confirmed the recent strength of the Italian real estate market and recent significant transactions included:

a the €200 million IPO of Coima RES, the first new REIT to be listed in Italy in several years;

b the €950 million acquisition of by Antin Infrastructures, Icamap and Borletti Group of the concession for the retail spaces of Italian major train stations (Grandi Stazioni); and

c the €200 million acquisition of St Regis and Westin Excelsior hotels in Florence by Nozu Hotels & Resorts, controlled by Qatari Jaidah Holdings.

ii Major transactions – 2015

In 2015, investment volume was up by nearly 55 per cent compared with 2014, driven by large transactions in Milan. The city accounted alone for 54 per cent of the total investment volume in Italy thanks to the following three large deals:

a the €900 million investment by Qatar Investment Authority in the Porta Nuova project in Milan;

b the purchase of the Isozaki Tower in Milan by Allianz for €367 million; and

c the sale of Palazzo Broggi in Piazza Cordusio in Milan to Fosun for €345 million.

iii Major transactions – 2014

2014 saw the consolidation of the Italian real estate market, with total investment volumes of €5.3 billion. The main transactions in 2014 included:

a the €400 million sale by Auchan of a retail portfolio to an Italian pension fund;

b significant transactions involving alternative products, such as bank branches, with two Intesa San Paolo (€175 million) and Deutsche (€134 million) portfolios being sold for total €342 million; and the acquisition by Qatar Holding of the Credit Suisse Italian headquarters in Milan; and

c the €180 million sale by Idea Fimit SGR of Forte Village, the prime luxury resort in Sardinia to a Russian family office.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

As mentioned, the public real estate market in Italy is very limited, and recent attempts to list new REITs have not always been successful. In 2015–2016, four new REITs have tried to list on the Milan Stock Exchange, and only Coima RES SIIQ was able to complete its IPO at the beginning of 2016.

The main REITs and REOCs (real estate operating companies) listed in Italy are the following:

a Beni Stabili (REIT), with a market cap as of 30 June 2016 of €1.2 billion, investing mainly in the office sector;

b IGD (REIT), with a market cap as of 30 June 2016 of €600 million, investing mainly in the retail sector;

c Coima RES (REIT), with a market cap as of 30 June 2016 of €300 million, investing mainly in the office sector;

d Aedes (REIT), with a market cap as of 30 June 2016 of €120 million, investing mainly in the office sector; and

e Risanamento (REOC), with a market cap as of 30 June 2016 of €155 million, a company that underwent a significant debt restructuring and that currently owns one of the largest development projects in the Milan area.

Legal and tax status

The Italian REIT regime was introduced in Italy by Law No. 296/2006, which provides for a special tax regime applicable to Italian-listed real estate investment companies (SIIQs) and whose main activity is the rental of real estate properties. The SIIQ regime is applicable also to non-listed Italian real estate investment companies (SIINQs), which are subsidiaries of SIIQs if certain conditions are met.

SIIQs benefit from a special tax status, which allows income from property rental to be exempt from IRES (corporate income tax) and (proportionally) from IRAP (Italian regional tax on productive activities). These profits are taxable for shareholders only upon their distribution as dividends. The tax-exempt income includes (1) income from rental activity, (2) gains or losses on real estate properties for lease and shares held in SIIQs/SIINQs or participations in certain real estate investment funds and (3) dividends from SIIQs/SIINQs and proceeds from certain real estate investment funds (together, 'tax-exempt operations').

Requirements for eligibility for the SIIQ regime

In order to benefit from the SIIQ regime, a company must (1) be established as a joint-stock company; (2) be resident for tax purposes in Italy;[4] and (3) have its shares traded on a regulated market in an EU or EEA Member State.[5]

In addition, the company's articles of incorporation must prescribe: (1) rules governing its investment policy; (2) limits on the concentration of investment and counterparty risks; and (3) a maximum limit on financial leverage at company or group level.

Dividend distribution requirements

In order to maintain their favourable SIIQ tax status, SIIQs must distribute in each fiscal year at least 70 per cent of the lower of (1) net profits from the tax-exempt operations and (2) total profits. At least 50 per cent of the proceeds deriving from net gains on property for lease and from the sale of interests in SIIQs, SIINQs or real estate funds must be distributed in the two fiscal years following the year in which they were realised.

Ownership requirements

No shareholder may hold, directly or indirectly, a stake in the SIIQ granting more than 60 per cent of the voting rights or more than 60 per cent of the rights to participate in profits. If these thresholds are exceeded as the result of extraordinary corporate actions or capital market transactions, the special SIIQ tax status will be suspended until compliance with the ownership requirement has been restored.

Furthermore, at least 25 per cent of the company's shares must be held by shareholders who do not directly or indirectly hold more than 2 per cent of the voting rights and more than 2 per cent of the rights to participate in profits.

The ownership requirements must be met by the first tax period for which the option is exercised, in which case the special tax status will be effective as of the beginning of that period.[(6)] Companies that only achieve the 25 per cent requirement by the end of the first tax period must comply with the additional 60 per cent ownership requirement within the next two tax periods; in such case, the special tax status will apply from the beginning of the tax period in which this ownership requirement is met.

Asset and income requirements

At least 80 per cent of the SIIQ's total assets must consist of (1) real estate properties (ownership and other rights, including finance leasing); (2) participations accounted as fixed assets in other SIIQs or SIINQs; or (3) shares in the certain real estate funds ('asset test').

At least 80 per cent of SIIQ's positive components of income must be: (1) proceeds from lease activity; (2) dividends from lease activity raising from participations in SIIQs/SIINQs/certain real estate funds; and (3) capital gains realised on real estate properties held to lease or from qualifying participants (point (2) above) ('income test').

4 The SIIQ regime also applies to the Italian permanent establishment of a foreign company established in the EU or EEA Member State.

5 SIINQ shares are not listed on a stock exchange.

6 The 2 per cent per cent threshold is required for the access to the SIIQ regime, but it does not affect SIIQ status after the election.

SIIQs and SIINQs must prepare their financial statements in accordance with international accounting standards. Both SIIQs and SIINQs will forfeit their special tax status if:

a they are no longer resident for tax purposes in Italy;
b they no longer have the form of a stock corporation;
c they fail to distribute the profits from tax-exempt operations subject to mandatory distribution; and
d they fail to conduct property rental as their main business.

The special tax status will not be applied should a SIIQ or SIINQ fail to comply with the asset test and the income test for the same tax period, or fail to comply with one of the two tests for three consecutive tax periods, effective as of the second tax period.

SIIQs are immediately disqualified from special tax status if their shares are no longer listed.

The option to obtain special tax-advantaged status

The special tax status for SIIQs is obtained by the company exercising an option before the end of the tax period prior to the one that it intends to benefit from the status. The option is irrevocable and requires the company to accept categorisation as a SIIQ or SIINQ, which must then be indicated in the company's name and in all the company's documents.

ii Italian real estate funds

Italian real estate funds are a very significant component of the Italian real estate market. At the end of 2015 there were around 400 real estate funds in Italy, holding properties with a value in excess of €50 billion.

Legal status

Under Italian law, real estate funds belong to the general category of investment funds and are considered alternative investment funds (AIFs) for the purpose of the AIFMD Directive.[7]

Investment funds are governed by Legislative Decree No. 58 of 24 February 1998 (the Consolidated Financial Act) and by the relevant implementing regulations.[8] The Consolidated Financial Act defines investment funds as:[9]

> *the investment scheme set up to provide the collective investment service, whose assets are collected from a plurality of investors through the issuing of units or shares and which is managed in pool and autonomously from these investors [...], in accordance with a predetermined investment policy.*

7 EU Directive 2011/61/EU of 8 June 2011.

8 Such regulations include: (1) the Ministry of Economy and Finance's Decree No. 30/2015, which sets out the general criteria applicable to Italian undertakings for collective investments (UCIs); (2) Bank of Italy's regulation of 19 January 2015, on the collective asset management rules; (3) the joint regulations issued by Consob and the Bank of Italy on 29 October 2007 (the Joint Regulations) and the regulations issued by Consob.

9 Article 1, Paragraph 1(k) of the Consolidated Financial Act.

Under Italian law, real estate investment funds are externally managed, on a collective basis, by their AIFMs (an Italian SGR or other authorised management company).

The AIFM must manage the fund separately from its investors. It must act independently and in the sole interest of the investors of the fund. In particular, under Italian law, SGRs undertake with regard to the investors in the fund the duties and responsibilities of a fiduciary. The AIFM is responsible for the management of the fund, including responsibility for all decisions to invest and divest the assets of the fund. Undue interference by the investors in the management of the AIF would jeopardise its legal and tax status.

The fund provides limited liability to its investors. The assets of the fund are separate and segregated from the assets of the SGR, the assets of other funds managed by the SGR, and the assets of the investors in the fund.

Italian investment funds do not have separate legal personality but are 'contractual structures' governed by their management rules.

The SGR drafts and approves the management rules of each fund. The management rules of 'retail' funds must also be authorised by the Bank of Italy, while the management rules of funds reserved to professional investors are simply communicated to the Bank of Italy following their approval by the SGR.

The management rules of a fund govern:

a the participation of the investors in the fund;
b the mutual rights and obligations of the SGR, the Depositary Bank and the fund's investors;
c the subscription and redemption of the funds' units;
d the types of securities and other assets in which the fund's assets may be invested;
e the distribution of profits;
f the procedures for the winding up of the fund;
g the reporting requirements; and
h the replacement of the SGR in the management of the fund with another SGR.

The management rules of investment funds reserved to professional investors typically provide for the institution of specific bodies that represent the interest of the investors, such as a unit holders' meeting and an advisory committee appointed by the investors in the fund. The advisory committee typically expresses its opinion on certain key matters relating to the management of the fund. The opinion of the advisory committee is generally non-binding, except in respect of conflict-of-interest transactions and the approval of the initial business plan of the fund and its material amendments. The governance rights of the investor may not prejudice the requirement that the fund must be managed by the SGR autonomously from the investors.

The investor may decide to replace an SGR in the management of the fund with an alternative SGR and the fund management rules may set out specific rules in connection therewith (e.g., grounds for replacement; notice period and termination indemnity resulting from the SGR being replaced; and thresholds for investors' approval for the replacement of the SGR).

Tax regime

Italian real estate funds that comply with the aforementioned regulatory conditions benefit from favourable tax regimes for the purposes of income and transaction taxes. Please note that such regimes may also apply with respect to funds run by a single investor, provided the latter qualifies as an 'institutional investor' (as further described below).

Tax regime of the fund

Italian real estate funds are not subject to corporate income tax and regional tax on productive activities. They are subject to VAT, according to general tax rules and the SGR is responsible for the fund's VAT compliance. The funds are subject to municipal taxes with respect to the real estate held.

Tax regime of the investors

Unit holders of Italian real estate investment funds are subject to different tax treatment depending on their nature, residence and on the size of their interest in the fund.

Italian-resident institutional investors[10] (independent of the amount and value of the fund's units held) and other investors owning units in the fund with a value no higher than 5 per cent of the overall value of the fund's net assets are generally subject to an advance 26 per cent withholding tax on the proceeds distributed by the fund. This withholding tax is a final tax with respect to certain investors (e.g., individuals) and does not apply to others (e.g., other Italian investment funds);

Italian-resident investors other than institutional investors owning units representing more than 5 per cent of the overall value of the fund's net assets are taxed on a 'look-through basis' (i.e., the fund's operating result is considered as attributed *pro quota* to the relevant investor and taxed accordingly, even if it is not distributed).

In terms of non-Italian resident investors the following investors are exempted from withholding tax: (1) pension and investment funds located in a white-listed country; (2) international entities and organisations established pursuant to international treaties; and (3) national banks and similar entities.

Other investors are subject to a final 26 per cent withholding tax upon distribution (that could be reduced according to relevant double tax treaties).

10 According to Article 32, paragraph 3 of Law decree No. 78 of 2010, institutional investors are: (1) the Italian state and Italian public bodies; (2) Italian investment funds; (3) Italian social security entities; (4) Italian insurance companies but only with respect to investments covering technical provisions; (5) Italian banks and financial entities subject to regulatory control; (6) entities listed from (1) to (5) above which are established abroad in a white-listed country; (7) private entities with mutualistic purposes and cooperatives resident in Italy; and (8) vehicles participated for more than 50 per cent per cent by one or more than entities listed from (1) to (7) above.

IV TRANSACTIONS

i Legal frameworks and deal structures

Given the very limited size of the Italian public real estate market, Italian property transactions are mainly structured as direct property acquisitions (asset deals) or acquisition of unlisted property companies. Below is described the current market practice for acquisition agreements of unlisted property companies (SPAs); similar considerations apply to agreements for direct property acquisitions.

Deal certainty and risk allocation

Acquisition agreements typically afford sellers strong deal certainty protection and there is generally strong resistance to any form of 'outs', such as material adverse change (MAC) conditions or finance-outs.

Especially in the context of auction processes for attractive portfolios, the approach tends to be seller-friendly, including: (1) limited scope of representations and warranties; (1) seller-friendly limitations on liability; and (3) seller-friendly disclosure provisions (e.g., it is becoming common to permit full data room disclosure).

Closing conditions

As previously mentioned, MAC clauses are rarely included in property transactions as a condition to closing. There are statutory provisions giving walk-away right if the transaction becomes 'excessively onerous', but financing is almost never a closing condition. Neither is it common to include a condition for general accuracy of the representations and warranties or covenants at closing.

Termination rights, even with termination fees for purchaser, are very rare. No show at closing by the purchaser will normally lead to claims for specific performance or damage claims.

Pricing

Property transactions typically provide for an adjustment mechanism on the basis of closing accounts. Lock-box provisions are very infrequent, even in the context of private equity transitions.

Escrow arrangements

Escrow arrangements are not very common in property transactions. They tend to be used in situations where the creditworthiness of the seller is a particular concern for the buyer or where the seller wishes to limit the extent of any other post-closing recourse.

Warranty and indemnity insurance

Warranty and indemnity insurance is not common, but it is gaining ground. Lower premiums on warranty and indemnity insurance, and the improved scope and quality of cover available, have led to an increase in the use of such insurance as a method of risk allocation, especially in private equity deals.

Representations and warranties given at signing and closing

Is it common to have all representations and warranties given at both signing and closing. SPAs may include the ability to make disclosures between signing and closing in order to prevent the seller from being exposed to a fraud claim. Typically, the buyer would still be able to bring a claim for breach of warranty but not fraud.

Sole and exclusive remedy provisions

Property transactions typically include exclusive remedy provisions, limiting the buyer's remedies to damages or indemnification only, rather than termination. Typically, exclusive remedy provisions do not include breach of covenants.

Monetary and time limitations

Property transactions (both corporate and asset deals) typically include *de minimis* (mini basket) thresholds. In property transactions these thresholds tend to be quite limited.

There is no clear prevalence between baskets as a tipping (first euro) or deductible (excess only) basket. The basket amount tends to be in the range of 1 to 2 per cent of the equity value.

It is very common to have a cap on the level of claim that a buyer can make. Typically, the cap applies to breaches of representations and warranties (with exceptions for fundamental representations and warranties (title, etc.) and, sometimes, for tax and environmental representations). Specific indemnities are often excluded from the cap (and uncapped or covered by their own cap). The typical range of the cap varies between 10 and 30 per cent of the deal value.

There is generally a time limitation of 12 to 24 months for general representations and warranties; there is also a statute of limitations for fundamental representations and warranties (title, etc.) and representations relating to tax and labour.

Covenants: interim conduct of business

Interim conduct provisions usually consist of a commitment not to perform certain specified actions without the buyer's consent plus a covenant to limit conduct in the ordinary course of business. Exceptions may be permitted in the form of specific carve-outs or materiality thresholds.

When a transaction is subject to prior antitrust clearance (infrequent for property transactions), any restrictions must be carefully designed so as not to trigger a change in control.

Choice of law and method of resolution

In general, domestic transactions are governed by Italian law if the properties are located in Italy. For pan-European deals clients are increasingly willing to consider a law different than their own based on several factors: (1) location of parties; (2) location of target or properties; (3) neutrality; (4) comparative advantages in the event of a dispute (e.g., treatment of damages or statute of limitation for claims). Finance documents (except for local guarantees) are often governed by English law.

Arbitration is the most common option in cross-border deals, with a preference for administered arbitration. In domestic transactions litigation is predominant, but arbitration is fairly common too. Mediation clauses are quite rare.

ii Financing considerations

Real estate financing is usually granted as a *mutuo fondiario* under Articles 38 et seq. of the Italian Banking Act,[11] which provides for a special regime applicable to medium and long-term loans (i.e., loans lasting for at least 18 months and one day) granted by Italian banks or Italian branches of EU-passported banks and secured by a first-rank mortgage over the property. To qualify for the *mutuo fondiario* regime, the loan-to-value ratio of the loan (i.e., the ratio between the amount of the loan and the value of property subject to the first-ranking mortgage in favour of the lenders) must not exceed 80 per cent.[12]

From the lender's perspective, the main advantage of structuring a financing as a *mutuo fondiario* is the higher degree of protection from the risk of insolvency of the borrower, as payments effected by the borrower under a *mutuo fondiario* are not subject to clawback actions under Article 67 of the Italian Insolvency Law;[13] also, mortgages granted to secure a *mutuo fondiario* are not subject to clawback actions if registered in the relevant cadastral register at least 10 days before the declaration of insolvency of the mortgagor.[14] From the borrower's perspective, the main advantage of the *mutuo fondiario* is that, in the event of a delay in loan payments, the rights of the relevant lenders to accelerate the loan are subject to certain restrictions (i.e., broadly, the lender will be entitled to accelerate the loan if a payment delay occurs at least seven times).

If the loan does not qualify under the *mutuo fondiario* regime, it will be subject to the general provisions of the Italian Banking Law and the Civil Code concerning financing and related security.

The typical security package securing Italian real estate financing includes, in addition to the mortgage:

a the assignment by way of security (or pledge) of the receivables arising from lease agreements entered into in relation to the property and related guarantees securing the lessee's obligations under the relevant lease agreements;
b the pledge over the bank accounts of the borrower (most notably the accounts into which the lease receivables of the borrower are to be paid);
c the assignment by way of security (or pledge) of the receivables arising from the interest-hedging agreements entered into in respect of the loan;
d the loss payee clause issued by the relevant insurer in respect of the property; and
e depending on the characteristics of the borrower, a pledge over share capital of the borrower or some form of parent company guarantee.

Since 2012 several legislative measures have been enacted to promote alternative lending activity in Italy. These measures have contributed to enhancing the lending market to include players other than banks as lenders. In particular, the direct lending market has been opened to Italian and EU alternative investment funds (AIFs); and securitisation vehicles.

11 Legislative Decree No. 385/1993.

12 See Article 38(2) of the Banking Act and implementing resolutions.

13 Royal Decree No. 267/1942.

14 While mortgages granted in respect of loans not subject to the *mutuo fondiario* regime are subject to a six-month – or one-year, depending on the circumstances – clawback period

Direct lending by AIFs

Following the implementation in Italy of the Alternative Investment Fund Management Directive, receivables are eligible assets for investment by AIFs, including 'receivables arising from financings granted out of the assets of the AIF'.

Decree-Law No. 18 of 14 February 2016 has amended the Italian Finance Act to introduce the following changes:

a Italian AIFs are now authorised to grant loans to borrowers (other than the retail public); and

b EU AIFs are authorised to invest in receivables in Italy and to grant loans, subject to conditions – a specific implementing regulation needs to be issued by the Bank of Italy.

The following apply to direct lending for EU AIFs:

a home regulator authorisation is required;

b the EU AIF may start operations only after 60 days from the notification to the Bank of Italy;

c to operate in Italy, the EU AIF must have a closed-ended form and its operating model must be comparable with that of Italian AIFs;

d risk management, concentration and leverage requirements of the home member state must be equivalent to those applicable in Italy; and

e regulatory duties in Italy include notification to the Central Credit Register and application of Italian transparency provisions.

Direct lending by securitisation vehicles

Decree-Law No. 91 of 24 June 2014 (known as the Competitiveness Decree) has allowed Italian securitisation vehicles to grant loans to borrowers other than individuals and microenterprises. The relevant Bank of Italy implementing regulations were enacted in March 2016 and provide the following legal framework for direct lending by Italian securitisation vehicles:

a the borrower must be selected by a bank or a financial intermediary;

b the notes issued by the special purpose vehicle can only be underwritten by 'qualified investors'; and

c the bank or financial intermediary that has selected the borrower must retain a significant economic interest in the transaction (i.e., at least 5 per cent) and must comply with the cash reserve ratio requirements.

V OUTLOOK

There was a significant increase in real estate activity in Italy in 2015-2016, mainly driven by the continuing interest of foreign institutional investors in the Italian real estate market. This positive trend is expected to continue in 2016–2017, thanks to the continuing expectation of low interest rates, with volumes driven by the arrival of significant property portfolios on the market from maturing funds, divesting pension funds, banks and other institutional and private investors.

Chapter 12

JAPAN

Masakazu Iwakura and Hajime Ueno[1]

I OVERVIEW OF THE MARKET

From the late 1990s, the Japanese market saw an increase in real estate investment, adopting more modern investment methodologies and techniques, including non-recourse loans, commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS) and other securitisations and structured finance, and the participants included not only Japanese real estate companies and financial institutions, but also Wall Street-style foreign investment banks and other investment firms. Non-recourse investment in real estate and other Wall Street-oriented model investments and loans rapidly increased until the market became sluggish in the latter half of 2007 and declined sharply in 2008 due to the global financial crisis. Some years of stagnantion in the economy followed, but since the December 2012 re-election of the prime minister, Shinzo Abe, the Japanese real estate investment environment has significantly improved under a series of economic measures adopted by the Abe administration, popularly referred to as 'Abenomics'. The awarding of the 2020 Olympic Games to Tokyo in 2013 also contributed to the overall increase in real estate investment in Japan. The continued depreciation of the yen has encouraged increased investment of foreign capital in Japanese real estate. At the same time, certain types of asset class in the real estate market have also become more attractive, including healthcare facilities and hotels.

In terms of market players, major public real estate companies domiciled in Japan such as Mitsubishi Estate Co Ltd, Mitsui Fudosan Co Ltd and Nomura Real Estate Holdings Inc tend to hold large amounts of assets and possess strengths in the development, management and operation of real estate; many of them have subsidiaries that are asset management companies of Japanese real estate investment trusts (J-REITs). Separate from these companies, there is another class of public real estate company in Japan, which is characteristic in the

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Japanese market: they belong to non-government owned railway company groups, such as the Tokyu Group, Hankyu Hanshin Toho Group and Kintetsu Group – historically, the development of railways and surrounding areas has created synergies between the real estate business and the railway business, especially when the Japanese economy experienced high economic growth after World War II.

Another key driver in Japan's recent real estate investment market is J-REITs. The J-REIT market was established in September 2001, when two J-REITs publicly listed their investment units on the Tokyo Stock Exchange (the TSE) for the first time. Since then, REITs have become popular in Japan among investors as a new type of moderate-risk product with stable returns. As of the end of April 2016, a total of 54 publicly listed REITs are operating, with a total market capitalisation of approximately ¥12.1 trillion, with total assets under management of approximately ¥14.6 trillion. This is nearing the total market capitalisation of the 55 public real estate companies listed on the First Section of the TSE (¥13.4 trillion).

When established, J-REITs are generally structured on the assumption that they will be listed in the future. However, the recent trend seems to be that not all J-REITs are intended to be listed. Since the creation of Japan's first private REIT in 2010, the market for such instrument has expanded to meet the needs of investors looking for long-term, stable investments. Private real estate funds that do not take the form of J-REITs are also active in Japan.

The TSE also established an infrastructure fund market on 30 April 2015 for listing funds that invest in infrastructure assets, including renewable energy facilities, power grids, and transport and transmission networks. On 2 June 2016, Takara Leben Infrastructure Fund Inc was the first infrastructure fund to be listed on the TSE.

II RECENT MARKET ACTIVITY

i M&A transactions

In October 2015, Nomura Real Estate Master Fund Inc, one of the largest diversified J-REITs,[2] was formed through an incorporation-type merger of former Nomura Real Estate Master Fund, Nomura Real Estate Office Fund Inc and Nomura Real Estate Residential Fund Inc. This was the first merger of publicly traded REITs since April 2012, and the 10th merger of publicly traded REITs since the J-REIT market was established in September 2001. It was also the first transaction where positive goodwill was recorded in a merger of REITs.

In April 2016, Daiwa House Residential Investment Corporation (DHI) and Daiwa House REIT Investment Corporation (DHR) announced that they would implement an absorption-type merger, with DHI[3] as the surviving corporation and DHR[4] as the absorbed corporation, with the effective date being 1 September 2016.

In May 2016, Nomura Real Estate Master Fund Inc (NMF) and Top REIT Inc (TOP) announced that they would implement an absorption-type merger, with NMF[5] as the surviving corporation and TOP[6] as the absorbed corporation, with the effective date being 1 September 2016, and which would create the second-largest publicly traded REIT in Japan.

2 With 261 properties and a total acquisition price of approximately ¥794 billion.

3 With 142 properties and a total acquisition price of approximately ¥256 billion.

4 With 41 properties and a total acquisition price of approximately ¥204 billion.

5 With 253 properties and a total acquisition price of approximately ¥795 billion.

6 With 20 properties and a total acquisition price of approximately ¥190 billion.

ii Private equity transactions

Some of the most significant real estate private equity transactions in the past few years are described below.

In November 2014, the Blackstone Group announced that funds affiliated with Blackstone Real Estate Partners Asia would make an investment in connection with an agreement to acquire GE Japan Corporation's residential real estate business consisting of approximately 200 residential properties for over ¥190 billion.

In December 2014, Advantage Partners, LLP announced that LL Holdings Inc, which belongs to a fund to which Advantage Partners LLP provides services, was acquiring Japanese real estate developer SBI Life Living Co Ltd from SBI Holdings Inc through a share tender offer (or a takeover bid (TOB)) for about ¥12.8 billion.

In March 2015, Bain Capital Private Equity announced that it would launch a take-private transaction for publicly traded Japan Wind Development Co Ltd,[7] in partnership with JWD's management. The transaction would take place in accordance with the TOB process, and the final purchase price of the TOB process was about ¥7.3 billion.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Public real estate companies

Public real estate companies in Japan are formed as companies (KKs) under the Companies Act of Japan. There were 55 public real estate companies listed on the First Section of the TSE at the end of April 2016, of which Mitsubishi Estate Co Ltd has the largest market capitalisation of approximately ¥2.95 trillion. The average market capitalisation of the 55 public real estate companies is ¥240 billion.

Publicly traded REITs

As previously noted, J-REITs are a type of investment fund formed under the Act on Investment Trusts and Investment Corporations of Japan (the Investment Trust Act). A J-REIT, which invests in and manages real estate assets, uses investors' funds to purchase real estate assets, in return for which investors receive investment units. The investment units of a J-REIT can be listed and traded on stock exchanges. Under the Investment Trust Act, there are two types of legal structure for J-REITs: investment corporations and contractual investment trusts. At the time of writing, all J-REITs with investment units listed on Japanese stock exchanges have been structured as investment corporations.

There are 54 publicly traded J-REITs listed on Japanese securities exchanges, of which Nippon Building Fund Inc has the largest market capitalisation of approximately ¥970 billion and a total asset acquisition price of approximately ¥1.08 trillion. The average market price of the 54 J-REITs is ¥220 billion, with the average total asset acquisition price being ¥270 billion.

7 JWD is a leading Japanese wind farm developer and operator in Japan.

Typical structure

Since an investment corporation is statutorily designed only to be an investment vehicle, it is not permitted statutorily to hire employees and is required to outsource most of its business operations to external service providers. For example, the investment management function must be outsourced to an asset management company (AMC) registered under the Financial Instruments and Exchange Act of Japan (the FIEA). In addition, all J-REITs also have one or more sponsors, although this is not a legal requirement. A sponsor typically acts as a promoter for the establishment of the AMC, which in turn acts as a promoter for the establishment of the investment corporation, to which it provides asset management services. The sponsor also acts as a main supplier of properties to the REIT. While adopting this REIT structure under the Investment Trust Act has its benefits in attracting investors and raising funds, for example, due to it being a specifically designed structure for investment purposes that statutorily mandates certain mechanisms to protect investors' interests, there is a longstanding theoretical concern over a potential conflict of interests between those of sponsors and those of unit holders. In order to address this concern, the Investment Trust Act was amended in 2013 to require the AMC to obtain prior consent from the investment corporation (based on the approval of its board of officers) before certain significant transactions between the investment corporation and interested parties of the AMC (such as the sponsor) are carried out.

The governance structure of a J-REIT formed as an investment corporation consists of the unit holders' meeting,[8] a board of officers formed by its corporate officers and supervisory officers, and an accounting auditor. Since, in practice, all investment decisions taken by an investment corporation are meant to be taken by its AMC, as previously mentioned, the principal responsibility of the corporate officers is to supervise the AMC.

Listing requirements

In order to be listed on a stock exchange, a REIT must meet various criteria, including: (1) the REIT's real properties must account for at least 70 per cent of all the investment assets held by the REIT, and the real properties and other assets related thereto must constitute at least 95 per cent of all investment assets, and (2) there being a provision in the REIT's articles of incorporation prohibiting the unit holders from requesting a redemption of their investment units.

Requirements for special tax treatment

An investment corporation is effectively a collective investment vehicle and is essentially a conduit for the distribution of profits. Therefore, unlike an ordinary corporation, an investment corporation is permitted to deduct distributions paid by it to its unit holders from taxable income for Japanese corporate tax purposes, subject to certain requirements under the Act on Special Measures Concerning Taxation. Such requirements are often referred to as 'conduit requirements' and include: (1) that more than 90 per cent of the distributable income under tax regulations must be distributed by the investment corporation to its unit

8 A decision-making body within an investment corporation that consists of all its unit holders, which is permitted to vote only on matters provided in the Investment Trust Act or matters specified in the REIT's articles of incorporation.

holders and (2) the investment corporation is not, as at the end of each fiscal period (normally a six-month period), a family corporation as defined in the Tax Code, meaning a corporation of which more than 50 per cent of its ownership is held by one unit holder and its affiliates.

Types of properties

The primary asset classes of REIT investments include offices, and residential and commercial facilities. In addition, the share of logistics facilities has increased recently.

Furthermore, in light of the ageing population of Japan, the Japanese government is looking to expand the number and availability of nursing services and hospitals, and issued guidelines for nursing facilities (in June 2014) and for medical facilities in (June 2015). In November 2014, the first REIT investing only in healthcare facilities and related real estate listed its investment units on the TSE. Currently, there are three healthcare REITs listed on the TSE.

Another category of investment assets that is increasing in Japan is hotel and accommodation facilities. There has been a dramatic increase in the number of foreign tourists visiting Japan in the past few years, possibly due to the government's promotion of inbound tourism to Japan, the awarding of the 2020 Olympic Games to Tokyo, and the recent depreciation of the yen. Thus, the demand for hotels and accommodation facilities has increased and is expected to continue to increase. At present, there are three REITs listed on the TSE that invest mainly in hotels.[9]

ii Real estate PE firms – footprint and structure

While it may be rather common for US-based private equity firms, such as KKR & Co LP and the Blackstone Group LP, to also engage in real estate investments, Japanese-domiciled firms' specialisations seem to be divided as real estate fund managers in Japan do not seem to cross over with private equity firms investing in various industry and company sectors.

According to the data aggregated by the Japan Investment Advisers Association, the average amount of assets under management of the top 50 real estate private funds was ¥134 billion as of the end of September 2015.

The most popular structures and investment vehicles used for real estate investments in Japan by real estate investment funds are the GK-TK structure and the TMK structure.

GK-TK structure

Typically, a limited liability company (GK) under the Companies Act acts as a special purpose company and holds an investment portfolio, and investors invest in the GK through a silent partnership (TK) agreement. Funds from the investors are pooled, and the asset manager has partial discretion to invest in unspecified real estate assets, with the real estate securities and earnings being distributed to investors. A TK arrangement qualifies for favourable tax treatment if the TK investor is a passive investor with minimal control over the management of the GK and the funds contributed under the TK arrangement. This tax-efficient combination of a GK and TK arrangement is called the GK-TK structure.

9 Japan Hotel REIT listed in June 2006, Hoshino Resorts REIT listed in July 2013 and Ichigo Hotel REIT listed in November 2015.

TMK structure

A TMK (*tokutei mokuteki kaisha*) incorporated under the Asset Liquidation Law is another type of corporate entity often used as a real estate investment vehicle. A TMK may only be used to liquidate or securitise certain assets. This type of investment platform is used to make investments in real estate, trust beneficial interests in real estate, and loans and TMK bonds that are backed by real estate. A TMK is typically funded by issuing TMK bonds and preferred shares that meet certain tax qualifications required for the TMK to receive preferential tax treatment. If a TMK, its bonds and its preferred shares are properly structured, and the TMK meets certain other requirements under the Tax Code, it is permitted to deduct all distributions to preferred shareholders from its taxable profits in addition to deducting debt payments.

IV TRANSACTIONS

i Legal frameworks and deal structures

Since M&A transactions of real estate companies are essentially the same as those of ordinary companies with the same applicable laws and regulations,[10] this section will focus on the legal framework and deal structure of M&A transactions concerning J-REITs.

M&A transactions concerning J-REITs are conducted primarily as a growth strategy for an existing REIT or as a means of entering into the J-REIT market by a prospective sponsor. There are few methods available for REIT M&A as not all of the schemes available for the M&A of ordinary corporations under the Companies Act are stipulated in the Investment Trust Act and are therefore not permitted in the context of J-REIT M&A. For example, with respect to investment corporations, the Investment Trust Act does not provide for the transfer of all or a substantial part of the business of a company, company split, share exchange or share transfer – all of which are available to ordinary stock companies.

The following schemes are, however, thought to be feasible for the purpose of J-REIT M&As: (1) acquisition of the shares of the AMC (sometimes combined with acquisition of units of the investment corporation) and (2) merger of two or more investment corporations.

Acquiring shares of an AMC

If an acquirer wishes to obtain control of a REIT's investment management function, acquiring the shares of the existing AMC managing that REIT's assets is the simplest and – in most cases – most efficient way of doing this, since it is not easy for the REIT's unit holders to replace the existing AMC with another AMC. The shares of the AMC are acquired or transferred for the purpose of replacing a sponsor or having a new sponsor participate in addition to the existing sponsors.

The acquisition of an AMC's shares is sometimes accompanied by the acquisition of the units of an investment corporation. An investor may acquire units either by subscribing for new units to be issued or by acquiring existing units through market transactions or takeover bids; all or most of the units would be acquired by subscribing for new units if the investment corporation needs additional funds. It is common for the new sponsor and its

10 Although special care must be taken in real estate M&A transactions to ensure that the entity continuing to conduct real estate trading business or investment advisory or investment management business post-acquisition holds the necessary licences.

group companies to acquire, in total, less than 50 per cent of the aggregate outstanding units of the investment corporation to comply with the tax conduit requirements. The acquisition of units of the investment corporation must comply with the FIEA regulations, including the takeover bid regulations. As such, in the event that an acquirer wishes to gain control over one-third of the units of a REIT without trading on the securities exchanges, it must utilise the takeover bid procedures prescribed in the FIEA. In light of the fiduciary duties owed by each officer to the investment corporation, it is understood that the board of officers must take into consideration not only the price offered but also other critical factors, including continued listing on the market, compliance with the tax conduit requirements, and sufficient protection of the interests of minority unit holders. There has to date been only one example of takeover bid procedures taken in relation to units of an investment corporation.

If the officers of the investment corporation are to be changed in conjunction with the acquisition of shares of the AMC, such change must be approved at a unit holders' meeting by a majority vote. In addition, various transactions often take place to establish the new sponsor's control, which include changes in the directors of the AMC, the execution of a sponsor support agreement, and amendments to the investment policy and other basic structures of the REIT or the AMC (or both). At the same time, the new sponsor often sells properties owned by it to the REIT.

In the event that shares of the AMC are acquired for the participation of a new sponsor in addition to the existing sponsors, the additional sponsor often acquires a minority interest in the AMC without acquiring units of the investment corporation. When the additional sponsor becomes a shareholder of the AMC, it is common practice for the current sponsors and the additional sponsor to enter into a shareholders' agreement for the purpose of coordinating their interests.

Incidentally, as most if not all AMCs of existing J-REITs are non-public unlisted companies, the hostile takeover of an AMC is virtually impossible; and as an AMC's articles of incorporation ordinarily contain a provision requiring that transfers of any of its shares be approved by the board of directors, the shares of an AMC cannot be acquired without the agreement of the AMC's current shareholders and the approval of its board of directors.

REIT mergers

There are two types of merger for REITs: (1) an absorption-type merger, in which all rights and liabilities of the dissolving REIT are transferred to the surviving REIT after the merger and the unit holders of the REIT to be absorbed receive units of the surviving REIT; and (2) an incorporation-type merger (consolidation), in which all rights and liabilities of two or more REITs are transferred to an entirely new REIT established upon consolidation. The consideration for the merger is basically limited to the units of the surviving REIT under the Investment Trust Act. However, cash payments upon mergers for certain purposes such as adjustment of fractions are allowed under the Investment Trust Act.

A REIT can only merge with another REIT – it cannot merge with a joint-stock company or any other corporation or entity other than a REIT. Incorporation-type mergers are less common than absorption-type mergers for various reasons, including the more complicated procedures involved in incorporation-type mergers. For this reason, the rest of this section will only cover matters related to absorption-type mergers.

The procedures for mergers of investment corporations are essentially the same as those for companies under the Companies Act. Under the Investment Trust Act, parties must enter into a written merger agreement on the fundamental terms and conditions of the contemplated merger. The merger must generally be approved by the board of officers at the board meeting and by the unit holders at the unit holders' meeting of both merging REITs. At the unit holders' meeting, a two-thirds or more vote of the investment units present at the meeting is required, and the quorum for the meeting must be a majority of the total number of issued and outstanding units. In the case of an absorption-type merger, however, unit holder approval is not required from the surviving REIT if the total number of investment units delivered from the surviving REIT to the dissolving REIT's unit holders as consideration for the merger does not exceed one-fifth of the total number of investment units of the surviving REIT (a 'short-form merger').

Moreover, certain disclosure procedures and creditor protection procedures stipulated in the Investment Trust Act must be adhered to. A dissenting unit holder may demand that the investment corporation purchase its units at a fair value. However, in the case of a short-form merger, dissenting unit holders of the surviving investment corporation may not demand that their units be purchased, unlike in the mergers of companies.

In addition, external service providers to which the surviving REIT will outsource its functions following the merger (such as the AMC) must be selected. For this purpose, the asset management agreement with the AMC not selected as the AMC of the surviving REIT following the merger must be cancelled with approval by a majority vote at the unit holders' meeting. Alternatively, the AMCs of the REITs to be merged may also merge concurrently with the merger of the REITs.

ii Acquisition agreement terms

Since M&A transactions of real estate companies are essentially the same as those of ordinary companies, with the same applicable laws and regulations as mentioned above, this section will focus on the typical terms of acquisition agreements concerning REITs.

The Investment Trust Act provides the minimum matters to be addressed in a merger agreement for investment corporations, which include:

a the trade names and addresses of the surviving corporation and the dissolving corporation;
b the number of units of the surviving corporation to be delivered upon the merger to the unit holders of the dissolving corporation *in lieu* of the investment units thereof, or the method for calculating the number of units, and matters concerning the total amount of investment of the surviving corporation;
c matters concerning the allotment of investment units to the unit holders of the dissolving corporation; and
d the effective date of the merger.

In practice, in addition to these matters, the merger agreement may also provide for certain conditions precedent such as obtaining consent to the merger from lenders to each investment corporation involved and obtaining approval of the unit holders' meeting of the surviving corporation with respect to amendment of its articles of incorporation or termination of the asset management agreement.

On the other hand, in a transfer of shares of the AMC, the share transfer agreement typically contains the following clauses:

a specification of the shares to be transferred and the transfer price;
b closing of the transaction;
c representations and warranties;

d covenants;
e conditions precedent;
f damages and indemnification; and
g termination.

The terms to be included in a definitive M&A agreement for REITs are negotiated between the parties and may depend on the purpose of the transaction, the attributes of the parties, the size of the target company and other factors.

Representations and warranties

In the representations and warranties clauses, the parties to the agreement represent and warrant the existence or non-existence of specific facts and rights or obligations, usually as at the signing date of the agreement and the closing date, including in transactions where a private equity firm is a selling party. The representations and warranties requested by the buyer usually cover various aspects of the target company's business and, in a case where the target company is an AMC, this would typically include the validity of permits or licences held by the AMC and its power and authority to manage the investments of the REIT. Representations and warranties are generally not provided in a merger agreement since there will be no party to claim damages against after the merger for breach of the representations and warranties.

Break fees and other deal protections

In recent years, the number of transactions armoured with deal protection clauses (e.g., break-fee clauses and exclusive negotiation clauses) has increased. However, because there are few court precedents regarding deal protection clauses – whether in the context of REIT M&As or M&As in general – it is unclear whether a court would uphold their validity, particularly when they might conflict with the fiduciary duties of a target's directors. With respect to break-fee clauses, if the break fee is unreasonably high, there is a possibility that a court might hold that the arrangement is against the public interest and declare it null and void.

On the other hand, reverse break-fee arrangements have yet to gain traction in Japan, including in transactions where a private equity firm is the purchasing party.

iii Hostile transactions

An example of a hostile takeover transaction with regard to public real estate-related companies is the unsuccessful hostile bid by PGM Holdings KK (Japan's second-largest golf course operator) to take over Accordia Golf Co Ltd (Japan's largest golf course operator) in 2013. Hostile takeover bids remain far rarer in Japan than in the US and certain European capital markets, and, due to cross-shareholdings, management-friendly investor blocs, and a variety of other defence mechanisms, no hostile bidder has succeeded in securing more than a majority stake in a major Japanese target.

The hostile buyout of a J-REIT has yet to occur. Assuming that the AMC of the target REIT is not a publicly traded corporation, the acquirer must:

a purchase units of the target REIT through market transactions or takeover bids and
b call a unit holders' meeting to resolve, *inter alia*:
   1 the cancellation of the asset management agreement between the target REIT and the existing AMC; and
   2 the approval of a new asset management agreement with the new AMC controlled by the acquirer.

However, the target REIT would lose its tax conduit status if a majority voting interest is held by one unit holder and its affiliates at the end of the fiscal period so (a) above is usually not practically feasible. In connection with (b), the articles of incorporation of an investment corporation often have a 'deemed consent' provision;[11] while this provision's application can be blocked by forcing the target REIT to have conflicting proposals be submitted to the unit holders' meeting, unless the hostile party forces such situation, this provision can make it easier for the incumbent management to retain the status quo in fending off the hostile takeover; on the other hand, from the perspective of the hostile party, coupled with the tax conduit requirement, it is going to be difficult for the hostile party to own 49.9 per cent of the outstanding units but still try to secure resolutions on (1) and (2) above, as the incumbent can block the application of this provision by simply having a proposal opposing the proposal by the hostile acquirer submitted to the unitholders meeting. Also, (b) above is not practically easy to achieve due partially to the fact that a hostile acquirer would need to solicit proxies from unit holders at its own cost.

iv Financing considerations

Where the acquirer is a stock company under the Companies Act, the acquisition may be (1) internally funded by the acquirer or (2) externally funded by the acquirer through equity financing or debt financing. Where the acquirer is a private equity fund, the acquirer itself usually does not become a debtor for the acquisition financing – a special purpose company incorporated by the private equity fund for the purpose of the acquisition usually becomes the debtor.

In the case of a merger between REITs, capital usually does not need to be raised for the merger since the consideration for the merger is basically limited to the units of the surviving REIT under the Investment Trust Act.

v Tax considerations

Tax considerations for M&A transactions of public real estate companies are essentially the same as those for M&A transactions of ordinary companies, with the same applicable laws and regulations.

With respect to REITs, the acquisition of shares of an AMC is a taxable transaction, and the seller will be subject to income tax on any gains. If the seller company is not a resident of Japan, it could be subject to Japanese capital gains tax; however, an exemption may be available depending on the percentage of its ownership of the shares or the applicable tax treaty. A merger of an investment corporation can be implemented without income taxation at the time of the transaction (in substance, tax deferral) if such transaction satisfies the requirements for tax-qualified restructuring.

In addition, the 2009 tax reform made it possible for a surviving REIT that obtains negative goodwill (i.e., unrealised gain of the dissolving REIT) by conducting a statutory merger to deduct the negative goodwill from its distributable income for the fiscal year as

11 A provision to the effect that if any unit holder does not attend the unit holders' meeting to vote and does not exercise their voting rights in writing, that unit holder shall be deemed to have voted in favour of the proposal submitted at that respective unit holders' meeting.

long as the gains are not realised, making it easier for the surviving REIT to satisfy the conduit requirements. Further, the 2015 tax reform enabled the inclusion in expenses of the distribution in excess of net income equivalent to the amortisation costs of the goodwill.

vi Cross-border complications and solutions

There are no direct restrictions on the acquisition, either directly or through a vehicle, of commercial or residential real estate in Japan by foreign investors. Similarly, the establishment of a corporation by foreign investors to invest in commercial or residential real estate is not restricted.

After a foreign investor acquires real estate or a right related to real estate, a post-transaction report to the relevant governmental authority is generally required pursuant to the Foreign Exchange and Foreign Trade Law (the FEFTL). In addition, after a foreign investor acquires shares or equity in a corporation, a post-transaction report to the relevant governmental authority may be required pursuant to the FEFTL.

V CORPORATE REAL ESTATE

In recent years, there has been a trend for Japanese companies that have corporate real estate to manage and operate such real estate strategically. The strategic management and operation of corporate real estate often takes the following forms: (1) outsourcing of asset management functions and property management functions; (2) separating the real estate assets from the company through a company split or business transfer under the Companies Act; or (3) securitisation using the GK-TK structure or TMK structure described above, or by utilising a REIT.

VI OUTLOOK

The market size of Japanese real estate investment is the second-largest in the world,[12] but considering the size of Japan's GDP, it is believed that there is still room for further expansion of the market.

In March 2016, the Ministry of Land, Infrastructure, Transport and Tourism's advisory panel of experts published a growth strategy for expanding the real estate investment market. The published growth strategy aims to increase the amount of assets under management by J-REITs to up to ¥30 trillion by 2020, which is approximately twice the current amount. The growth strategy points out that measures should be taken to encourage expansion by J-REITs into assets in growing sectors such as the tourism, logistics, and healthcare industries. It is expected that the implementation of such measures in the near future would further promote the growth of the J-REIT market in the mid to long term, and to increase the number of real estate M&A transactions as a means of new entry into the REIT market or of achieving external growth by existing REITs.

12 'Japanese Real Estate Market, Today' (2015), published by the Land Economy & Construction Industries Bureau, the Ministry of Land, Infrastructure, Transport and Tourism of Japan.

Chapter 13

KENYA

Anne Kiunuhe, Mona Doshi, Daniel Ngumy and Caroline Karugu[1]

I OVERVIEW OF THE MARKET

The real estate sector has rapidly grown to become one of the key contributors to the Kenyan economy,[2] with a booming property market responding to extraordinary demand from an emerging middle class for high-end residential, retail and office space and facilities. This growth may be attributable to the increased investment in real estate companies by private and public-listed investors and the development of new real estate models such as real estate investment trusts (REITS) within the Kenyan market.

Recent trends in the market have seen the establishment of real estate development companies with the capacity to undertake large-scale property development projects. One such company is Centum Investment Company Limited, a company established in 1967 as an affiliate of a Kenyan state corporation and which is now listed on both the Nairobi Securities Exchange (NSE) and Uganda Securities Exchange. Since 2014, Centum has been developing the Two Rivers development, a five-year, 100-acre fully integrated mixed-use development in Gigiri, Nairobi County, which in 2016 is valued at over US$166 million.

Other major listed real estate companies include Home Afrika,[3] which was listed on the NSE in 2013 undertaking various large-scale real estate development projects including Migaa, an integrated golfing estate on approximately 800 acres of land in Kiambu County.[4]

1 Anne Kiunuhe, Mona Doshi and Daniel Ngumy are partners, and Caroline Karugu is a senior associate at Anjarwalla & Khanna.

2 Trade Economics, 'Kenya's Annual GDP Growth Rate 2004-2016'. Available at www.tradingeconomics.com/kenya/gdp-growth-annual, accessed on 14 June 2016.

3 Eric Ombok, 'Kenya's First Listed Property Developer Plans Two REITS' Bloomberg, on 18 July 2013. Available at www.bloomberg.com/news/articles/2013-07-17/kenya-s-first-publicly-held-property-developer-plans-two-reits, accessed on 9 June 2016.

4 Such developments include: Migaa, Mitini, Tamarind Residence Migaa, Llango, Lakeview Heights and Kantafu Gardens.

It should be noted that the concept of REITs is fairly new in Kenya, with regulations for the same having only been gazetted in 2013 under the Capital Markets Act. The first Kenyan REIT[5] was the Stanlib Fahari I-REIT, issued by Stanlib Investments in October 2015.[6] It had also been reported that the NSE intended to list two new REITs in the first quarter of 2016; however, so far this has not materialised.[7]

In contrast to REITs, private equity firms have been very active in investing in the real estate sector in Kenya in the recent past, and according to a survey by Deloitte and Touche, one of the favoured destinations for private equity activity in Africa is Kenya.[8] One significant recent deal in Kenya was a US$100 million joint venture entered into by Helios Investment Partners, a leading Africa-focused private equity fund and Acorn Group, a with large property developer providing capital for Acorn's acquisition, construction and development of various real estate projects in the country.[9] This joint venture followed the acquisition by investment firm British American Asset Managers (Britam) of a 25 per cent stake in Acorn in 2013 for the financing of Acorn's development projects.[10] It should be noted that in 2015, Britam entered into an agreement with Helios to relinquish its stake in the property developer.

In terms of foreign direct investment (FDI) into Kenya, there has been a significant increase in funding for projects since 2013 with more than US$500 million-worth of FDI in 2013 and nearly US$990 million-worth of FDI a year later in 2014.[11] A notable FDI transaction involved Centum, which received funding by way of an equity investment of 6.4 billion Kenyan shillings in April 2015 from Aviation Industry Corporation of China

5 Upon its listing, Home Afrika expressed an intention to raise capital for its projects through the establishment of a REIT but this has not come to fruition. George Ngigi, 'Home Afrika gives REITs notice' *Business Daily*, on 11 November 2013. Available at www.businessdailyafrica.com/Home-Afrika-gives-REITs-notice/-/539552/2069444/-/4gut92/-/index.html, accessed on 9 June 2016.

6 John Gachiri, 'Stanlib REIT goes for NSE listing after attaining minimum threshold' *Business Daily*, on 27 November 2015. Available at www.businessdailyafrica.com/Stanlib-Reit-fails-to-hit-target-as-T-bill-locks-in-investors-/-/539552/2973742/-/3ejdss/-/index.html, accessed on 9 June 2016.

7 Duncan Miriri, 'Kenya bourse expects to list two new REITs in Q1' Reuters, on 4 December 2015. Available at www.reuters.com/article/kenya-reit-idUSL8N13T1OZ20151204, accessed on 9 June 2016.

8 Deloitte, 'African Private Equity Confidence Survey 2015.' Available at https://www2.deloitte.com/content/dam/Deloitte/za/Documents/finance/za_private_equity_confidence_survey_may2015.pdf, accessed on 14 June 2016.

9 David Herbling, 'Private equity firm Helios inks joint deal with Acorn' *Business Daily*, on 5 November 2015. Available at www.businessdailyafrica.com/Corporate-News/Helios-inks-joint-deal-with-Acorn/-/539550/2944276/-/6tmd2u/-/index.html, accessed on 9 June 2016.

10 November, 2013. Available at www.standardmedia.co.ke/business/article/2000097731/britam-acquires-25pc-of-acorn-group-shares-ups-presence-in-property-sector, accessed on 14 June 2016.

11 Santander, Trade Portal, 'Kenya: Foreign Investment'. Available at https://en.portal.santandertrade.com/establish-overseas/kenya/investing, accessed on 9 June 2016.

(AVIC), a Chinese state corporation, for its mixed-use real estate project at Two Rivers[12] which was reported to be one of the largest foreign direct investments in the region from a Chinese state corporation to a private enterprise.

II RECENT MARKET ACTIVITY

i M&A transactions

With regards to M&A transactions, there has not been much significant activity in the sector recently as most investors opt for joint venture or private equity models. However, in 2016 a key M&A deal saw Old Mutual, a UK-based financial services group, and Centum reach an agreement for the acquisition by Old Mutual of a 50 per cent stake in Two Rivers Lifestyle Centre Limited (which in turn owns Two Rivers mall, which makes up a portion of the larger Two Rivers development) for 6.4 billion shillings. Old Mutual had also acquired a majority stake in UAP Holdings in 2015 after buying out three private equity firms that held a combined 37.33 per cent stake.[13] UAP Holdings is an insurance firm with sizeable commercial real estate portfolio and projects including Union House, Equity Centre, Telkom Plaza and UAP Towers, which is currently the tallest building in Nairobi.

Also in 2015, Britam finalised its acquisition of 2.7 billion shillings-worth of shares in Housing Finance,[14] which is the leading mortgage provider in Kenya and which also undertakes real estate developments.

ii Private equity transactions

In private equity, the most significant transaction relates to the construction of Garden City, a US$250 million integrated mixed-use property development along the Nairobi–Thika superhighway in Nairobi County, which comprises a 500,000 square feet shopping centre, offices, hotel and 600 residential units. It has been developed by Actis, a leading private equity investor partnering with CDC, the UK's Development Finance Institution, and the International Finance Corporation (IFC), and was opened to the public in May 2015.[15]

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12 John Gachiri, 'China firm buys Sh6.4bn stake in Centum's Two Rivers' *Business Daily*, on 7 April 2015. Available at www.businessdailyafrica.com/Corporate-News/China-firm-buys-Sh6-4bn-stake-in-Centum-project/-/539550/2677480/-/o0hjldz/-/index.html, accessed on 14 June 2016.

13 Victor Juma, 'Old Mutual raises stake in UAP after Sh14bn buyout' *Business Daily* on 27 January 2015. Available at www.businessdailyafrica.com/Corporate-News/Old-Mutual-raises-stake-in-UAP-after-Sh14bn-buyout-/-/539550/2603170/-/1276u88z/-/index.html, accessed on 27 June 2016.

14 Mugambi Mutegi 'Britam finalises buying Sh2.7bn Equity shares in HF' 5 January 2015. Available at www.businessdailyafrica.com/Corporate-News/Britam-finalises-buying-Sh2-7bn--Equity-shares-in-HF/-/539550/2579426/-/108gui7z/-/index.html, accessed on 27 June 2016

15 CDC, 'CDC and IFC have announced an investment of US$32m in Garden City, a new mixed-use real estate development in Nairobi, Kenya' on 15 January 2014. Available at www.cdcgroup.com/media/news/cdc-and-ifc-invest-in-garden-city-to-create-jobs-and-new-business-opportunities-in-nairobi-/#sthash.2zWsLBXR.dpuf, accessed on 14 June 2016.

Private equity firms are increasingly enhancing their presence in the real estate sector in Kenya. Traditionally, most real estate developments have been undertaken by family-owned companies that owned prime undeveloped land. The landowners acquire bank debt and undertake the development on their own or alternatively partner with individual developers to undertake the development. Some of the large real estate developments that have been undertaken in this manner are the Edenville development (situated along Kiambu Road, approximately 10 kilometres from Nairobi's city centre), which, when completed, will comprise approximately 800 residential town houses, the Karibu Homes development (situated in the Nairobi County), which will comprise 1,000 low-end residential units, and the Greenspan Estate (situated in the Nairobi County), a mixed-use development comprising a shopping centre and residential homes made up of apartments and townhouses. Information regarding the value of these developments is not in the public domain.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

In 2013, the Capital Markets Authority of Kenya (CMA) introduced the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations (the REIT Regulations). The REIT Regulations provide for the legal framework for REITs and establishes two classes of REIT:

a development and construction real estate investment trust schemes (which provide for investment in development and construction projects) (D-REITs); and

b income real estate investment trust schemes (which provide for investment in existing income-generating real estate projects) (I-REITs).

The REIT Regulations regulate the offers and listing of REITs, management of REITs, the specific requirements of each type of REITs, and also provide for the establishment of Islamic REITs.

A validly issued REIT is required to (1) be established under a trust deed, (2) be structured as an unincorporated common law trust divided into units and (3) have a trustee, a REIT manager and a promoter.[16] The roles and requirements of the trustee, REIT manager and the promoter are set out in detail in the REIT Regulations.

D-REITs, in which the investors pool their monies together for purposes of acquiring real estate with a view to undertaking development, construction projects and associated activities, may be structured as open-ended or closed-ended funds and may be converted from one status to another.[17]

An offer or issue in a D-REIT may only be made as a restricted offer to professional investors in minimum subscription parcels of 5 million shillings.

16 Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013 regulation 5.

17 Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013 regulation 9(1).

I-REITs, in which the investors pool their monies for purposes of acquiring long-term income-generating real estate including housing, commercial and other real estate, may be the subject of either restricted or unrestricted offers but may only be structured as closed-ended funds.[18]

REITs can only invest in eligible real estate, which is defined under the REIT Regulations as real estate situate in Kenya and which has an unexpired residual term of 25 years. This means that REITs listed in Kenya cannot invest in property situated outside Kenya.

Section 20 1(c) of the Income Tax Act (ITA)[19] provides that unit trusts and REITs registered by the Commissioner 'shall be exempt from income tax except for the payment of withholding tax on interest income and dividends as a resident person as specified in the Third Schedule to the extent that its unit holders or shareholders are not exempt persons under the First Schedule'. All distributions of income and all payments for redemption of units or sale of shares received by unit holders are deemed to have already paid tax. This means that a REIT (being a separate and distinct vehicle from its unit holders) is tax-exempt provided it meets the criteria set out above. The dividend distribution to the unit holders in the REIT will, however, be subject to withholding tax.[20] Any interest paid on loans by the REIT to its unit holders will also not be exempt from withholding tax.[21]

A REIT is tax efficient because there is no corporation tax paid on trading gains, as would be the case with a corporate entity (the corporate tax rate is 30 per cent). Where a REIT has been listed on the NSE, the trading of units is not subject to capital gains tax or stamp duty, making REITs very tax efficient when undertaking real estate development.

ii Real estate PE firms – footprint and structure

As previously mentioned, the Stanlib Fahari I-REIT is the only REIT so far listed in Kenya. Stanlib offered 625 million units priced at 20 shillings each during the initial public offer, targeting a maximum of 12.5 billion shillings but was only able to raise 3.6 billion shillings owing to what was reported as 'competition from other instruments and the market's poor grasp of the concept'.[22] The REIT listed on the NSE having surpassed the minimum threshold required of 2.6 billion shillings. It is currently in the process of finalising the acquisition of the Greenspan Mall shopping centre for approximately 2 billion shillings.

Most private equity firms in Kenya enter into joint venture (JV) agreements with landowners in which the private equity firm finances development activities with an aim of exiting the project after a certain number of years. Some private equity firms, however, opt to acquire land and develop it themselves, without entering into JV arrangements. An example

18 Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013 regulation 9(2).

19 Cap 470, Laws of Kenya.

20 Withholding tax on dividends paid to resident persons and non-resident persons is 5 per cent and 10 per cent, respectively.

21 Withholding tax on interest income is 15 per cent.

22 John Gachiri, 'Stanlib REIT goes for NSE listing after attaining minimum threshold' *Business Daily*, on 27 November 2015. Available at www.businessdailyafrica.com/Stanlib-Reit-fails-to-hit-target-as-T-bill-locks-in-investors-/-/539552/2973742/-/3ejdss/-/index.html, accessed on 9 June 2016.

of such a fund is the Actis fund, which directly acquired 32 acres of land in Nairobi County to develop the aforementioned Garden City, currently the largest development in east and central Africa with more than 400 high-end residential units.[23]

For JV arrangements, a common framework is for the private equity firm and the developer to set up a new entity jointly (either a limited liability company (LLC) or a limited liability partnership (LLP)), which would acquire the land for development. Upon completion of the development, the entity will either lease the property to tenants or sell units in the development to individual or corporate buyers. One exit option available to private equity firms is to transfer the property into a REIT, which is thereafter listed at the NSE. Another exit strategy is to transfer the underlying reversionary interest in the land into a separate new company, which is wholly owned by the purchasers of the units in the development.

IV TRANSACTIONS

i Legal frameworks and deal structures

When undertaking an M&A or JV transaction relating to a real estate entity, knowledge of all the laws relating to land and land ownership in Kenya is essential. Land laws in Kenya have remained very fragmented, with over 20 different statutes governing land ownership and interests relating to land.

In 2010, Kenya promulgated a new Constitution, paving the way for an overhaul of the land law systems in Kenya. In 2012, the Kenyan legislature enacted new land laws: the Land Act,[24] the Land Registration Act,[25] and the National Land Commission Act.[26] The new statutes repealed and made amendments to some of the old land laws such as the Indian Transfer of Property Act of 1882, the Registered Land Act[27] and the Registration of Titles Act.[28] That notwithstanding the new land laws failed to achieve their stated objective of fully consolidating the land laws in Kenya.

Other legal considerations depend on the intended use of the underlying asset. One needs to be familiar with all laws that govern the construction and development of real estate. Such laws include the Physical Planning Act,[29] the Environmental Management and Coordination Act[30] and the Land Control Act.[31] These statutes set out the requisite approvals and consents for undertaking a real estate development as well as the cost and process involved. These approvals include change of user, building approvals and environmental approvals.

The parties must also understand the manner in which the development will be sold or leased to potential purchasers. Knowledge of the various land-planning structures is key, for example, benefits of sale by way of long-term leases, subdivision and use of the Sectional

23 www.act.is/our-portfolio/garden-city-retail/.
24 Act No. 6 of 2012.
25 Act No. 3 of 2012
26 Act No. 5 of 2012.
27 Cap 300, Laws of Kenya.
28 Cap 281, Laws of Kenya.
29 Cap 286, Laws of Kenya.
30 Cap 387, Laws of Kenya.
31 Cap 300, Laws of Kenya.

Properties Act[32] are important. Since most unit sales in developments are undertaken off plan prior to construction, the terms of the sale agreement between the project company and the potential unit purchasers should be properly structured and will usually include substantive provisions on the parties' obligations.

The initial phase of a JV arrangement is the transfer of the land into the JV entity, which requires certain tax considerations. Where properly structured, the transfer of property to the JV company can enjoy stamp duty exemption (see Section IV.v, *infra*).

The transfer of the land into the JV company will take the form of a straight sale and purchase of property, with the landowner and the JV company executing an agreement for sale. Once completion occurs as provided for under the agreement of sale, the registration formalities are undertaken at the relevant lands registry to register the transfer of the land in favour of the JV company.

The landowner and the private equity firm would usually execute a share subscription agreement or a shareholders' agreement (or both) to govern their relationship throughout the term of the JV arrangement.

Depending on the tax structuring, the consideration paid by the landowner (i.e., the land) and the consideration paid by the private equity firm (i.e., liquidity), the transaction can be structured as either as wholly equity or wholly debt or a combination of debt and equity transaction.

The use of LLPs instead of LLCs to undertake real estate developments is increasing. LLPs have the advantage of being transparent vehicles for the purposes of tax, while at the same time offering the partners the protection of limited liability. When the project entity is structured as an LLP, the landowner and the private equity firm will enter into a partnership deed instead of a shareholders' agreement and instead of subscribing for shares, the parties will acquire stakes in the LLP. There are, however, certain tax benefits that accrue solely to LLCs that should be considered depending on the nature of the transaction. It is also important to note that when seeking debt funding, an LLC can issue a debenture to secure the repayment of the debt while an LLP cannot, making an LLC more attractive to potential lenders.

ii Acquisition agreement terms

Structuring a JV or an M&A transaction relating to a real estate entity requires extensive due diligence to be undertaken to ascertain ownership and the authenticity of the title to the underlying asset (i.e., the land). Due to the parlous state of the records at the land registries in Kenya, as well as the documented abuse of original documents (including forgeries and multiple title allocations), due diligence on land involves more than just a title search at the lands registry. It will usually also involve engaging a surveyor to confirm the physical coordinates and attributes of the land as well as to confirm that the records at the various government agencies are valid and have been properly issued.

Due to the lengthy period of time it takes to undertake the due diligence, the transaction documents will usually provide for the due diligence process to be a condition precedent to the completion of the transaction and will allow the private equity firm to withdraw from the transaction at any time prior to completion in the event the due diligence is not satisfactory.

32 Act No. 27 of 1987.

The warranties provided by the landowner and the JV company are usually extensive and very specific to issues relating to land. Examples of some of some of these warranties are:

a a warranty that the land was acquired in accordance with and in compliance with the terms of all approvals, consents, permissions and authorisations required from any government authority;

b a warranty that the land is not subject to any overriding interest that would grant a third party non-registrable interest in the land; and

c a warranty that there are no boundary issues relating to the land and that the description of the underlying asset is correct, and the size and other conditions relating to the land are true in all respects.

A common provision in real estate JV arrangements is that the JV company will not issue any dividends until all units in the underlying development are completely sold. This is because for the initial period during construction, the JV company is usually in a loss-making financial position and will only be in a position to issue dividends once the whole development is sold. Certain JV arrangements will allow for the issuance of some of the units in the development to the shareholders as dividends *in specie*.

Usually, the voting requirements will call for passing of resolutions through a majority vote except for in certain reserved matters that may call for either a vote of shareholders holding an aggregate of 75 per cent or more or a unanimous vote. One such instance is where the private equity firm that, in most instances, is the majority shareholder also has a majority stake in the entity that is undertaking the construction or project management. In such a structure, owing to the potential conflict, there will be certain reserved matters set out in the shareholders' agreement such as the remuneration of the project manager or the extension of time on the project that would require the landowners' consent

Under the Competition Act,[33] all M&A and JV arrangements in or outside Kenya that result in a change of control in an undertaking in Kenya require the approval of the Competition Authority of Kenya (CAK). A 'change of control' is not defined under the Competition Act, but Section 41(2) of the Competition Act provides different ways in which a merger may be achieved, which include the purchase of shares. Section 41(3) of the Competition Act defines when a person is deemed to control an undertaking. Some of the forms of control listed under Section 41(3) include beneficial ownership of more than one-half of the issued share capital of the undertaking, the ability to control a majority of the votes that may be cast at a general meeting, the ability to appoint a majority of the directors, and the ability to materially influence the policy of the undertaking.

The CAK has issued merger threshold guidelines (Threshold Guidelines), which were applicable from 1 August 2013. The effective threshold is 1 billion shillings in combined assets or turnover of the parties. The Threshold Guidelines are, however, not legally binding but provide guidance to parties on the circumstances under which a transaction may be considered for exclusion and where a full notification is required. The Threshold Guidelines, however, do not afford parties an automatic exclusion from the provisions of the Competition Act, and parties are nonetheless required to file an application to the CAK for exclusion.

33 Act No. 12 of 2010.

iii Hostile transactions

There do not appear to have been any hostile transactions relating to public real estate companies.

iv Financing considerations

JV and M&A transactions are funded through a mixture of both equity and debt. The equity component is usually invested at the onset when the private equity firm or other private investors are acquiring a stake in the JV entity. Real estate transactions are also largely funded through bank debt. Recently, international banks have been willing to extend debt for the development of large real estate developments; a good example of this is Standard Bank of South Africa, which has financed the development of the Garden City shopping centre. Local banks are also participating in debt financing of large-scale real estate developments such as KCB Bank's lending to finance the Garden City residential development and Co-operative Bank lending to finance the Two Rivers development.

v Tax considerations

The following are the key taxes that apply to real estate transactions. Stamp duty is a tax charged on the transfer of land and shares, and is payable at a rate of 4 per cent of the value of the land in respect of the transfer of land situated in a municipality and 2 per cent of the value of the land outside the municipalities. On the transfer of shares, the stamp duty payable is 1 per cent of the consideration of the shares.

Sale and leasing of commercial buildings is also subject to VAT at the standard rate of 16 per cent.

Capital gains tax (CGT) was reintroduced in Kenya with effect from 1 January 2015 after having been suspended in 1985. CGT is chargeable on the whole gain that accrues to any individual or corporate body on the transfer of property (includes land and shares) situated in Kenya, at a rate of 5 per cent of the gain. This gain is determined as the excess of transfer value over the property's adjusted cost.

vi Cross-border complications and solutions

Although there are no foreign exchange controls in Kenya, there are a number of challenges faced by real estate developers (including private equity firms) in Kenya, especially with respect to funding strategies and extraction of profits from Kenya. For foreign-owned companies, thin capitalisation restrictions limit the deductibility of interest for corporate tax purposes where the debt-to-equity ratio is greater than 3:1. In addition, interest-free loans provided by foreign shareholders are subject to deemed interest provisions that require a notional interest (based on the prevailing Treasury Bill rates) to be computed and withholding tax at the rate of 15 per cent paid to the Kenya Revenue Authority on a monthly basis.

Extraction of profits by way of dividends is subject to withholding tax at a rate of 10 per cent when paid to non-resident shareholders. In addition, 'compensating tax' (at a rate of up to 42.86 per cent) may be triggered where the company making the dividend payment does not have sufficient credit in its dividend tax account. In addition, Kenya has transfer pricing rules that require transactions between Kenyan entities and foreign related parties to be undertaken at arm's length, which limits the extent to which management fees or royalties, for example, can be used to extract profits from the Kenyan entity.

There are various tax-structuring options available for real estate entities to address the challenges discussed above, including the use of quasi-equity instruments to deal with funding restrictions. It should also be noted that LLPs are tax transparent and they therefore provide a suitable vehicle for use in real estate development; however, where an LLP is wholly owned by foreign partners, there are certain tax-structuring aspects that should be considered carefully.

With regard to landownership, the Constitution provides that foreigners and corporations not wholly owned by Kenyan citizens cannot hold freehold interest in land or a leasehold interest in land for a term exceeding 99 years.

Moreover, under the current law, non-citizens are restricted from acquiring agricultural property. The Land Control Act provides, *inter alia*, that any sale, transfer, lease, exchange, partition, sub-division or other dealing in agricultural land or the sale, transfer, mortgage or other dealing in any share of a private company that owns agricultural land is void for all purposes unless the land control board for the area in which the land is situated has issued its consent in respect of that transaction. The Land Control Act further provides that the land control board will refuse consent in any case in which the land or share is to be disposed of by way of sale, transfer, lease, exchange or partition to a person who is not a citizen of Kenya or a private company all of whose members are Kenyan citizens. There are, however, structuring methods adopted that can enable a non-Kenyan to acquire interests in agricultural land.

A vast majority of land in Kenya is agricultural land and therefore any foreigners wishing to acquire the same, or to acquire shares in a company that owns agricultural land, would first have to obtain a change of user in respect of the land or, alternatively, adopt relatively complex structuring methods that permit the holding of shares in the landholding company by non-Kenyans.

V CORPORATE REAL ESTATE

An operating company/property company deal (opco/propco) is a strategy in which a company is divided into at least two parts:

a a property company that owns all the property, assets associated with generating revenues; and

b an operating company that uses those assets to generate revenues.

Opco/propco deals are becoming increasingly common in the Kenyan market as a result of various reasons. First, they provide flexibility on disposal or exit, as either the operating business or the property can be disposed of independently or new investors can invest at either the propco or opco level. From a tax perspective, there are various issues that should be considered before adopting an opco/propco structure. For example, there are no provisions allowing for set-off of tax losses for entities of the same group. This therefore means that in an opco/propco structure, one entity might be in a tax-paying position while the other entity has tax losses that it continues to accumulate. In addition, from a value added tax (VAT) perspective, related parties are required to transact on an arm's-length basis and, as such, the propco would be required to charge the opco rent at market rates. The VAT charged by the propco could end up being a sunk cost in some instances, as there are currently no provisions allowing for VAT groups in Kenya.

VI OUTLOOK

The outlook over the next few months is that large-scale real estate development entities will continue to attract investment from local and foreign investors, which will require complex structuring and legal documentation to specifically cater to the specific issues relating to mergers and acquisitions in the real estate sector.

Chapter 14

MEXICO

Alejandro Trujillo[1]

I OVERVIEW OF THE MARKET

The real estate market has rapidly evolved in Mexico over the past seven years since new legislation was introduced to promote new instruments in which to invest in long-term return sectors and activities. Capital development securities (CKDs) and Mexican real estate investment trusts (FIBRAs) boosted capital market investment in real estate.

Nevertheless, the origins of the Mexican institutional real estate market started in the late 1990s after the 1995 economic crisis in Mexico. In 2009, CKDs made their entrance into the market to provide an investment alternative for qualified players that had the ability to understand the risks of investing in long-term projects with no fixed returns. Mexican pension funds were the natural target for the issuance of CKDs at a time of diminished liquidity for developers, given their need to invest more aggressively to seek more attractive returns for their members.

CKDs are basically securities issued by a trust listed on the Mexican Stock Exchange. CKDs differ from shares as they have an expiration term to be repaid that may not be longer than 50 years. CKDs are fully regulated by the Mexican Securities Commission and the issuer trust must comply with corporate governance and reporting regulations, and can only be subscribed by qualified institutions (as opposed to FIBRAs, which are open to the general public).

Considering the risk tolerance of addressee investors and the uncertain return nature of long-term projects, CKDs are appealing for real estate companies to use as financing vehicles for the development of their projects.

In 2010 Mexico's first FIBRA was listed on the Mexican Stock Exchange and today there are more than 10 FIBRAs on the Mexican market. A FIBRA consists of a Mexican trust that issues securities (real estate trust securities (CBFIs)) that are placed on the capital markets for the general public to invest in. Specific rules apply to FIBRAs as they are also

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regulated by the Mexican Securities Commission, one of the most important being the investment of a substantial part of their capital in rent-generating properties (as opposed to CKDs, where assets do not need to exist at the time of the IPO and may be developed in the future).

Today there is correlation between CKDs and FIBRAs in that CKD funds are the future sellers of assets under their development to FIBRAs, considering that there are few large portfolio inventories left in Mexico that FIBRAs have not already acquired.

Private equity funds have also played an important role in the development of a sophisticated market in Mexico. Prudential is one of the pioneers creating club deals to invest in different asset classes (from multi-family to shopping centres to residential). Other companies such as Walton Street Capital, Black Creek, Blackstone and Credit Suisse are now investing in Mexico in different projects (on the equity and lending sides), in some cases through joint ventures with local players who participate with promotion fees and equity in exchange for providing property management services to those firms. Private equity real estate ventures are made in Mexico through investment promotion corporations (SAPIs), limited partnerships (LPs) or trusts, where the sponsor is the general partner, investors have a more passive role with some pre-approval rights and the local partner carries out the day-to-day operations over the assets.

II RECENT MARKET ACTIVITY

i M&A transactions

In July of 2012, Vesta was the first commercial real estate developer and asset manager to lunch an IPO and to become a public company listed on the Mexican Stock Exchange. At that time, Vesta had an important pool of German investors and a portfolio of 85 industrial properties covering more than 1 million square metres, mostly in central and northern Mexico, with revenues in 2011 of $50.3 million.

Macquarie, in December 2012, sponsored the IPO of FIBRA Macquarie, seeding a $1.5 billion industrial portfolio acquired from GE Capital Real Estate and Corporate Properties of the Americas, where GE Capital Real Estate and MetLife provided the seller with acquisition financing of $734.5 million and $182.5 million, respectively.

In December of 2013, Mexico Retail Properties (an affiliate of Black Creek) sold 49 retail properties located in 20 jurisdictions throughout Mexico, their corresponding management platforms and other related assets to FibraUNO for a purchase price of $2 billion.

Prudential's FIBRA (Terrafina) acquired, in September 2013, from Kimco Realty Corp and its partner in Mexico, American Industries, an industrial portfolio of 87 properties in $600 million of 11 million square feet.

In April of 2015, Prudential Real Estate Investors sold 22 retail properties to FibraUNO for $700 million.

In June 2015, Mexican real estate company Grupo Gicsa set its price per share at 17 pesos in an IPO of up to 7.2 billion pesos for local and foreign investors. Gicsa, which builds and operates high-end residential developments, shopping centres and offices, sold 368.4 million shares without considering an optional greenshoe allotment of 55.2 million shares.

ii Private equity transactions

In May of 2013, Kimco sold a nine-property Mexican shopping centre portfolio of 2.6 million square feet, to Planigrupo for $274 million.

BK Partners and Vertex acquired Mexico City's Hotel Four Seasons in June 2013.

In December of 2014, Finsa and Walton Street Capital, through their CKD1, completed the acquisition of a $302 million industrial portfolio of 35 stabilised properties in major Mexican markets, plus 160 hectares of land for future development from IDI Gazeley Brookfield Logistics Properties.

In August 2015, Blackstone acquired from GE its commercial real estate lending business in Mexico for $3.7 billion. GE granted $3 billion of seller financing to Blackstone for the transaction.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

FIBRAs are equity securities issued by Mexican trusts, which are similar to real estate investment trusts. They are created by a real estate sponsor with a trustee (usually a banking institution). A FIBRA has an asset manager that manages the operations and properties of the FIBRA.

Since FIBRAs are listed on the stock exchange (locally in Mexico and globally in the international markets), any person may invest and acquire their CBFIs. CBFI holders are represented by a common representative institution that is in charge of carrying out cash distributions to investors. There is usually a subsidiary project trust or special purpose vehicle (SPV) that holds each asset or portfolio, allowing leverage segregation per asset.

The two main governing bodies of a FIBRA are the security holders' meeting and the technical committee.

The security holders' meeting is in charge of approving, *inter alia*, the change of manager, amendments to the trust, an increase in fees to the manager or members of the technical committee, policies for obtaining credit facilities and investments worth equal to or more than 20 per cent of the trusts estate's value (10 per cent when the transaction may represent a conflict of interest). A meeting may be called by 10 per cent of security holders, who can also designate one member of the technical committee to represent them; 15 per cent of security holders are able to request enforcement of legal actions against the manager and 20 per cent of them may dispute the resolutions of any meeting in court.

The technical committee has a maximum of 21 members, of which 25 per cent must be independent. The committee is in charge of approving, *inter alia*, investment policies, transactions worth equal to or more than 5 per cent of the trust's estate value, related-party transactions, supervising the manager's performance and the creation of ancillary committees.

The characteristics of a FIBRA are:

a 70 per cent of their assets must be invested in real estate properties or rights;

b their properties must be leased or destined to be leased;

c assets may not be sold in the four years following acquisition or construction to preserve tax benefits; and

d they must make distributions once a year (usually there are quarterly distributions) to CBFI holders of at least 95 per cent of net tax results.

FIBRAs were introduced to the Mexican capital markets in 2011 and have grown since then from one FIBRA (FibraUNO) with a market capitalisation of $300 million to 10 FIBRAs with a total market capitalisation of $18 billion today. They have also raised around $6.5 billion through follow-on offerings, primarily in the form of blind pools.

FIBRAs in Mexico have also opened new ways for real estate investors and developers to dispose of their assets and cash out their investments by sponsoring the creation of a FIBRA and becoming its manager or selling the assets to an existing one at better prices than the market saw before the existence of FIBRAs.

Although the FIBRA market is still young and there is not yet general asset specialisation by all FIBRAs, some of them specialise in certain asset classes. For example, FibraHotel targets only business-class hotels in large cities, Fibra Shop targets shopping centres, and FIBRA Prologis focuses on industrial buildings. Other FIBRAs tend to have a variety of property types: FibraUNO has industrial, retail and schools, FIBRA Macquarie industrial, retail and offices, and Fibra Danhos retail and offices.

Although FIBRAs are definitely the most popular investment vehicle, the Mexican real estate market has also in the past five years seen a few IPOs of real estate operators, in Vesta, Gicsa and Planigrupo.

The challenge for real estate operators in Mexico, which have traditionally been family-owned businesses, is getting used to being highly regulated once listed on the stock exchange (with corporate governance that includes independent members of the board and continual reporting to authorities and investors) while also competing with FIBRAs for assets in the market (without the tax benefits of FIBRAs). On the positive side, not being a FIBRA has proven to be a good choice for real estate operators with a land bank and development strategy, since they are not restricted to maintaining 70 per cent of their assets on a lease-up mode (as FIBRAs do). This gives them more flexibility in their plans for construction and land reserve acquisitions.

ii Real estate PE firms – footprint and structure

Real estate private equity firms in Mexico are also fairly new. There are more than 15 funds dedicated to real estate. Some of the best-known private equity companies are PGIM (formerly Prudential Real Estate Investors), Walton Street Capital, MIRA (in partnership with Black Creek), Blackstone, Artha Capital, Thor Urbana, Prologis, IGS, CPA and MRP.

Mexico does not have specific regulations for private equity firms. The general structure of a private fund includes three groups of participants: investors, a fund manager or general partner, and SPVs or project entities. The fund manager is in charge of structuring and operating the fund and usually makes equity investments of between 1 per cent and 5 per cent of total capital, charges a management fee of 1.5 per cent to 2.5 per cent of total commitments, and receives a promotion fee of around 20 per cent of profits after investors' expected yield (6 per cent to 10 per cent average annually).

In order to create a fund, the manager incorporates at least two legal entities (the investment vehicle and the managing company). It is desirable that the investment vehicle may be considered transparent for tax purposes in order for different types of investor to coexist, such as pension funds and other tax-exempted companies with other local and foreign investors that accumulate income at different tax rates. The target is to avoid any taxation for the vehicle and to have all tax effects directed towards investors, who can then benefit from their respective tax regimes.

The two most common forms of investment vehicles are the Mexican trust and the SAPI. Trusts in Mexico may be set up as transparent vehicles for tax purposes and do not have legal restrictions in terms of the agreements between parties regarding exit rights and obligations, rights of first refusal, veto rights, and different rights and classes for participants. Trusts usually have a technical committee that acts as the managing body. SAPIs are legal entities with better and more sophisticated rules with respect to minority rights, shareholder agreements and corporate governance than regular limited liability companies in Mexico. SAPIs are governed by the shareholders' meeting and a board of directors, and may include different classes and rights for shares, and impose share transfer restrictions, voting limitations, separation and stock amortisation rights, rights of first refusal and different dividend treatment for classes of shares. Furthermore, in terms of minority rights, in SAPIs 10 per cent of the shareholders may designate one board member and one examiner to represent them (as opposed to regular limited liability corporations, which require 25 per cent), 15 per cent of shareholders may enforce legal actions against the board or manager and examiners (as opposed to regular limited liability corporations, which require 33 per cent) and 20 per cent of shareholders may dispute the resolutions of any shareholders' meeting in court (as opposed to regular limited liability corporations, which require 33 per cent). SAPIs are entities that are set up ready to be listed on the stock exchange (if ultimately an IPO is desired). It is important to note that SAPIs are not transparent vehicles and pay their own taxes; however, foreign investors may still benefit from international treaties with Mexico to avoid double taxation.

In recent years, Mexican legislation changed to authorise Mexican pension funds (AFOREs) to invest in CKD vehicles on the Mexican Stock Exchange. Therefore, many real estate private equity firms have set up and launched their own CKDs in the capital market to gain access to AFORE funds. The typical structure for CKDs is to have the sponsor become the manager of the assets to be acquired and developed by subsidiary project trusts. As opposed to the CBFIs of FIBRAs, CKDs do not have a *de facto* secondary market for the securities to be traded on nor follow-ons to raise more money (except for certain permissible capital calls), and have an expiration term to be repaid that may not go beyond 50 years.

Although CKDs are usually used for development and construction, in some cases funds are utilised to acquire stabilised assets. However, based on the characteristics of CKDs, and the fact that target investors are qualified institutions with better risk tolerance, a CKD is the perfect vehicle with which to speculate in land bank acquisition and construction, which, again, once stabilised, may be disposed of to a FIBRA in exchange for a favourable capitalisation rate exit.

IV TRANSACTIONS

i Legal frameworks and deal structures

As previously mentioned, the most important real estate players in Mexico are FIBRAs, REOCs listed on the Mexican Stock Exchange, and private equity firms with CKDs listed on the Stock Exchange. Considering that FIBRAs, CKDs and most private funds use Mexican trusts, SAPIs and (in fewer cases) limited liability corporations to set up their investment vehicles, the laws and regulations that govern buyers' and sellers' conduct in Mexico are the General Law Governing Credit Titles and Transactions, the General Law Governing Commercial Corporations, the Capital and Security Market Law and the Federal Antitrust Law (for tax considerations, see Section IV.v, *infra*).

The General Law Governing Credit Titles and Transactions regulates the creation of Mexican trusts, which is a type of commercial contract where assets are settled into a trust by a settlor who transfers them to a trustee in charge of representing the trust and preserving the trust estate (usually a Mexican banking institution with a trustee division). The beneficiaries of the trust have their rights established in the trust agreement.

The General Law Governing Commercial Corporations regulates the incorporation of mercantile legal entities such as limited liability corporations. It sets out the minimum requirements for the existence of each type of corporation and the rules for partner coexistence.

The Capital and Security Market Law regulates the issuance of securities and the listing of entities and securities on the Mexican Stock Exchange, a requirement for FIBRAs and CKDs to raise funds. It also provides the rules for the incorporation and operation of SAPIs.

The Federal Antitrust Law regulates the thresholds for transactions to be cleared with the Mexican Antitrust Commission prior to closing.

In closing sale and purchase transactions, the parties always consider different perspectives when structuring a deal. The most important aspects to consider are the tax effects for both parties and the legacy liabilities that may be transferred to buyers. Usually, the seller would prefer to sell the legal entity holding the assets to avoid triggering payment of deferred tax liabilities. On the other hand, buyers would most likely choose to buy assets directly into a newly formed SPV, avoiding any previous liabilities that sellers may have had during their ownership and operation of the assets.

Real estate transactions in Mexico have increasingly followed the US model and it is now common to see the following in large deals:

a letters of intent with confidentiality and exclusivity provisions in exchange for an escrow of 5 per cent to 10 per cent of the purchase price;
b master purchase agreements with extensive representations and warranties;
c conditions precedent;
d execution of closing documents;
e indemnities with deductibles, baskets and caps; and
f Foreign Corrupt Practices Act clauses.

For FIBRAs and CKDs to acquire an asset, if the property value is equal to or higher than 20 per cent of the total value of its assets at that moment (10 per cent when the transaction may represent a conflict of interest), the security holders' meeting (CBFIs or CKDs) will be the body in charge of approving such acquisition. If the property value of the target assets is between 5 per cent and 10 or 20 per cent, the technical committee makes the decision. In all other cases, special purpose committees (e.g., investment committee) or the asset manager may decide.

In private equity funds, the general partner makes capital calls within capital commitments to acquire new assets and in some cases, based on the size of the deal, the board of directors would have to approve, depending on whether the fund is discretionary or non-discretionary.

All other material decisions such as mergers, dissolutions or selling of the entire business are subject to the approval of security holders' meetings (FIBRAs and CKDs) and the partners or parties to the trust (for private equity funds).

When a portfolio of properties located in different cities throughout Mexico is the target of an acquisition, it is challenging to obtain title information from all the property registries as each has its own way of functioning and not necessarily all of them have the same systems and technology. Closing of multi-jurisdictional deals is complex and requires flawless notary coordination to assure accurate and timely information on each property and payment of property transfer taxes and registry duties.

Title insurance in acquisitions is also becoming standard practice in Mexico, mostly for funds sponsored by US companies. Local players do not tend to use it and prefer to rely on property registry information obtained during due diligence.

Antitrust filings are necessary in Mexico if the thresholds under the Federal Antitrust Law are met, even if the acquiring party has no participation in the relevant industry and there is no increase in market share from the transaction. Thresholds take into account the purchase price of the transaction with an impact in Mexico, the assets and sales of the target in Mexico, the capital stock involved in Mexico, and the global assets and sales of participants. Approval should generally be obtained within 60 days of filing being complete and the transaction may not close unless clearance is issued by the Mexican Antitrust Commission.

Another trend is the analysis of non-compete clauses by the Antitrust Commission being made with a higher level of scrutiny. Therefore, all parties that wish to include non-compete clauses in their transactional documents should be aware that generally their duration should not exceed three years and they should only involve parties and goods or services that are directly related to the transaction. Otherwise, parties run the risk of being heavily questioned on the content of their non-compete clauses and, in some cases, a transaction's approval might be conditional on the amendment of existing non-compete clauses.

ii Acquisition agreement terms

There are different types of transactions for the acquisition of real estate properties in Mexico. The most common are stock purchase agreements, asset sales and purchase contracts, joint ventures and private equity fund structures.

A stock purchase agreement is usually preferred when the seller intends to sell its stake in a joint venture or the entire real estate business. A sub-type of this category is the sale of beneficiary rights under a Mexican real estate trust. Also tax considerations and current leverage being in place are reasons to choose this structure.

Asset sale and purchase transactions are generally carried out if the buyer does not want to assume the liabilities of existing legal entities holding assets or to segregate assets into clusters, or have them transferred to the estate of a FIBRA.

Deals start with a letter of intent covering the most important aspects of the transaction, including target assets, purchase price, due diligence period, escrow, exclusivity and confidentiality.

In some cases, depending on the complexity of the transaction, a master purchase agreement is executed with a layout price, assets, pre-closing conditions (e.g., release of liens, clearance from the Antitrust Commission), representations and warranties, prorated share of income from assets prior to and post-closing, indemnities (including baskets, deductibles, caps), and non-compete, non-solicitation and confidentiality clauses.

Whether a deal closes as a stock purchase or an asset sale, the most important and common terms and conditions are the following:

a purchase and sale;
b representations and warranties;
c conditions precedent;
d closing;

e covenants;
f indemnities; and
g transitional service agreements.

iii Hostile transactions

No hostile transactions have occurred yet in Mexico regarding public real estate companies or FIBRAs, nor are they viewed as a threat at this moment; however, the consolidation of FIBRAs may be expected in the coming years.

iv Financing considerations

There are two traditional commercial real estate lending structures in Mexico. One is the standard corporate credit transaction used mostly by banks. In this type of structure, a bank performs a market valuation of the assets based on asset class, construction and location, and determines the proceeds of the loan considering such valuation. A mortgage and a corporate guaranty are requested (usually a pledge over the borrower's shares). The other loan structure used by lenders such as GE Capital Real Estate (before it was sold to Blackstone in 2015) is a non-recourse asset-based loan with a loan-to-value ratio based on the valuation of cash flow coming from rents (present and *pro forma* considering roll-over and down-time periods in terms of asset class, location, market, competitors and inventory). This type of structure usually targets portfolios that are cross-collateralised under a guaranty trust collateral agreement. If the assets do not have enough cash flow to cover debt service, the lender cannot ask the borrower to complete payment with resources other than from secured properties. The currency of the loan is arbitraged based on the currency of the lease agreements. In most cases, industrial leases are dollarised and those of offices can be mixed (some leases in dollars and some in pesos). Retail takes place mostly in pesos.

Another form of financing transactions is the placement of CKDs by private equity funds to obtain resources from AFOREs and other qualified investors.

FIBRAs have also reached out to the capital markets to obtain unsecured financing through the issuance of bonds, which have shown to give them better pricing (all-in rates) than typical banks do. The challenge for FIBRAs to issue this type of financing instrument is that most of the portfolios that they have acquired from third parties come with loan assumptions, and the usual negative pledges in unsecured bond issuances have restrictions on FIBRAs having mortgages or other type of guaranties over their assets. To respond to the bond threat, banks are starting to grant unsecured loans to FIBRAs by syndicating the risk among them, with more flexibility on negative covenants to preserve a market share against bonds.

v Tax considerations

As previously mentioned, tax considerations for structuring a sale and purchase agreement depend on the tax impact for each party. In addition to legacy liabilities, other costs and taxes for acquiring assets should be considered by the buyer, such as transaction recording fees with property registries,[2] as well as property transfer taxes, which is locally regulated and may range from 2 per cent to 6 per cent of the purchase price.[3]

Private equity funds have different options to structure their investment vehicles from a tax perspective. One option is to create a Mexican trust that is deemed a transparent vehicle for tax purposes, meaning that the settlor or beneficiaries (or both) would bear the tax effects of the transactions. If the trust is revocable and the settlor may revert the property of the assets settled into the trust, the settlor will be considered the party responsible for the taxes over the transactions of the trust. On the other hand, if the trust agreement states its irrevocability, the beneficiaries will bear all tax effects.

There also exists a special type of trust called a capital risk investment trust (FICAP). An important characteristic of FICAPs is that Mexican tax laws recognise that the participants of the trust may have different income tax rates (e.g., exempted pension funds or foreign investors) and allows them to benefit from their respective tax regimes by paying taxes according to their respective tax regime or jurisdictions. This type of trust was put in place in Mexico to offer an alternative to private equity firms using Canadian LPs for their investments in Mexico, which was recognised as a transparent vehicle for tax purposes (under tax law interpretation by some players). FICAPs have different requirements and limitations such as:

a investing at least 80 per cent of their assets solely in stocks of target companies or providing financing to them;
b a prohibition on selling the stocks of the target companies for two years after the acquisition;
c no more than 10 per cent of annual income coming from service rendering;
d 80 per cent of income being distributed annually to beneficiaries; and
e having a maximum duration of 10 years.

If a private equity firm prefers to acquire assets instead of shares, project companies subsidiary to the FICAP may be incorporated to acquire assets directly and the FICAP can then acquire the shares of the project companies.

FIBRAs are considered transparent for tax purposes with the holders of CBFIs bearing tax effects of the transactions of the FIBRAs. However, income tax in connection with the transfer of real estate assets to a FIBRA may be deferred for the benefit of the transferee, if the transferee receives CBFIs in exchange for the assets, until such time as a CBFI holder sells the CBFIs. In many jurisdictions within Mexico, FIBRAs defer property transfer taxes until the CBFI holders sell their CBFIs. With respect to each year's tax result, the trustee of the FIBRA is responsible for withholding the applicable income tax and no provisional payments are required.

Pension funds such as AFOREs are exempt from paying income tax from their yields over CBFIs and CKDs.

2 Some jurisdictions do not have a cap and calculate fees on purchase price.

3 In the event of buying the entity holding the assets, these taxes may not be paid, unless the entity is a Mexican trust and buyer acquires the seller's beneficiary rights over the trust. Property transfer taxes would be triggered when beneficiary rights under a trust are transferred to a third party.

vi Cross-border complications and solutions

There are no special withholding tax regulations for foreign owners of property in Mexico. Nevertheless, foreign purchasers face different types of complications in Mexico.

Some US investors are used to retaining title insurance for their transactions and under Mexican regulations, title insurance for Mexican assets may only be obtained from insurance companies registered and authorised by the Mexican Insurance Commission and operating in Mexico. Although 10 years ago there were several international title insurance companies with established operations in Mexico, today, there is only one remaining in Mexico and, therefore, the offering is limited.

Another factor to consider is that foreign legal entities and individuals may directly acquire and own land in Mexico[4] by waiving the right to invoke the protection of their country of citizenship in connection with the relevant real estate asset, therefore, being deemed Mexican nationals for that purpose only (i.e., subject to Mexican regulations and courts on land and property). In such case, aliens must, prior to the land purchase:

a gain a permit from the Mexican Ministry of Foreign Affairs to carry out the land purchase if Mexico does not have diplomatic relationship with the alien's country; or

b file the waiver acceptance with the Mexican Ministry of Foreign Affairs if Mexico has diplomatic relationship with the alien's country.

Foreign legal entities and individuals may indirectly acquire and own land in Mexico in the restricted area (other than for residential purposes) by participating in or setting up a Mexican legal entity that files acceptance of the waiver with the Mexican Ministry of Foreign Affairs and providing notice of the acquisition within 60 days. Foreign legal entities and individuals may indirectly acquire rights to use land in Mexico for residential purposes in the restricted area through a Mexican trust with a Mexican authorised financial institution as trustee, by obtaining a permit with the Mexican Ministry of Foreign Affairs to that effect. There are no restrictions on aliens leasing land in Mexico other than observance of the usual local and civil laws also applicable to nationals.

V CORPORATE REAL ESTATE

There is not yet a trend in Mexico to separate, in the real estate business, operating companies from property companies; however, non-real estate players with large numbers of properties are disposing of their assets to FIBRAs and other real estate operators. This has been the case for universities, franchises and even banking branches.

Another important change in the real estate arena in the past five years is the migration of the traditional real estate business of developing, owning or holding, and managing assets to a business of management fees, where developers have seeded their properties into FIBRAs and become their property managers and operators, focusing in some respects on the returns from fees charged to the FIBRAs.

CKDs have also seen private equity players seeking operating and promotion fees from pension funds in their listed investment vehicles.

4 Other than in the 'restricted area', which conforms a strip of land of 100 kilometres along borders and 50 kilometres along beaches.

VI OUTLOOK

The Mexican real estate industry has evolved rapidly in the past five years since the creation of FIBRAs and CKDs, both types of vehicle being listed on the Mexican Stock Exchange and the international markets, allowing individual and sophisticated investors to participate with equity in the real estate sector. Furthermore, small developers have become institutionalised players and large international investors have entered the country through joint ventures with local real estate operators or directly by setting up operations in Mexico. Title insurance has also become a practice in Mexico, giving more confidence to foreign lenders, while Mexican banks are now a competitive financing choice too. Finally, the public registries of property are in the process of updating and digitising their data, which will make them faster and friendlier to due diligence and real estate transactions in general.

In the near future there may be consolidation of FIBRAs, and more FIBRAs moving to specialise in asset classes. Investments from AFOREs in CKDs will continue to grow as AFOREs (with funds of around 3.8 billion pesos) have so far only invested 3.8 per cent of their funds in CKDs of the 20 per cent that some of them are authorised to invest and 1.9 per cent in FIBRAs of the 10 per cent that some of them are also authorised to invest.

Private equity firms will continue to develop retail, industrial and office buildings, which they will eventually sell to the FIBRAs at the end of the investment period. Some of them will sponsor and create their own specialised FIBRAs with their portfolios.

Multi-family will become a new asset class in Mexico, where FIBRAs and CKDs will look to maximise their liquidity and amplify their size when the inventory of class A stabilised assets is running off and will have to wait until private equity players build and lease up new properties.

Financing of projects and assets will continue to be supported by bonds issued by FIBRAs in the capital markets and unsecured syndication lending to support FIBRAs complying with maximum allowed debt ratios under the Securities Regulations. Nevertheless, new players like Blackstone and Credit Suisse will bring new commercial real estate structures through CKDs and mortagage REITs to serve as their source of funds in order to provide lending to other FIBRAs, CKDs, real estate operators and private equity firms. New lending structures will most likely be need to be put in place to keep up with regulations and the needs of real estate players (mezzanine loans, recourse corporate credits, flexibility to asset guaranty releases and substitutions, and unsecured lending transactions).

Chapter 15

NETHERLANDS

Lodewijk Hijmans van den Bergh, Mark Rebergen and Frederik Corpeleijn[1]

I OVERVIEW OF THE MARKET

Recent years have seen a growing appetite for real estate among investors, and investment volumes in the Dutch real estate market have been steadily increasing. In 2015 the reported investment volume was €11.6 billion, the highest since 2007.[2] Dutch institutional investors have returned as important investors in prime assets. German investors, who dominated the top deals in the past few years, are still active but less dominant, and private equity firms from overseas (especially from the United States) are more active than before, aiming both at core and opportunistic segments. Asian investors have also made their long-expected entrance to the Dutch real estate market.

Overall, there has been a significant increase in the share of foreign investors in the total investment turnover in recent years. In 2015, more than half of all investments came from foreign investors, compared with approximately one-fifth in 2009. Most of those foreign investors in 2015 were from the United States, the United Kingdom and Germany. About three out of four deals are carried out by sophisticated investors, especially institutional investors and private equity.[3]

The increased activity of sophisticated – often foreign – investors has in turn led to more variety in deals, including the use of documentation based on that of corporate M&A transactions. That said, most deals, including significant transactions, are still structured as asset deals and the impact of the increased activity of such investors on deal structures should not be exaggerated.

1 Lodewijk Hijmans van den Bergh and Mark Rebergen are partners, and Frederik Corpeleijn is an associate at De Brauw Blackstone Westbroek NV.

2 CBRE Research report 'The Netherlands Real Estate Market Outlook 2016' (http://nieuws.cbre.nl/download/140864/2016capitalmarketsoutlook.pdf), p. 7.

3 Idem, p. 9.

A change these investors have brought is the general way real estate deals are prepared and analysed from a commercial perspective. Specialists with a financial background play a significant role and often the financial due diligence seems to be the top priority, having more impact on decisions than the gut feelings of a real estate professional for whom the look and feel of a property used to be equally important.

Another trend is the shift from single-asset deals to portfolio deals, which – in a country where the value of single properties rarely peaks above €150 million – has led to a number of transactions with significantly higher deal values than before.

The residential sector and premium office spaces have stayed at the top of most investors' wish lists in the past eight years; the retail sector is subject to quite some turmoil. The most notable example is department store group V&D, which was declared bankrupt at the end of 2015. The group, over 125 years old, had 62 department stores throughout the country. Over 10,000 employees lost their jobs. For the retail sector, it means a big hole in the city centre of many cities. A number of other retail groups are facing similar issues.

In all segments the Randstad area (the combined greater Rotterdam, Amsterdam, The Hague and Utrecht area) is most popular by far; for offices, the Amsterdam Zuidas district is the nation's top office location.

A typical feature of the Dutch real estate market is the presence of almost 400 housing associations that own large numbers of residential properties. Their portfolios comprise about 30 per cent of the whole Dutch residential sector, with a market value of about €250 billion (2013).[4] These housing associations were set up in in the 19th century to provide subsidised housing for the poor. The applicable regulatory framework was very restrictive. Sales of properties outside the social sector were hardly possible. Recent changes in legislation made it easier for housing associations to sell off parts of their portfolio to commercial parties, although approval from the Dutch government authorities is still required. This increased freedom to sell off assets, especially where the monthly rent payments are above a certain defined threshold, resulted in the sale of several large residential portfolios to foreign REITs and private equity firms. It led to a spurt of deals and many investors (domestic and foreign) are still focusing on those portfolios. Since 2015, the demand from investors has greatly exceeded supply; this gap may even have widened as a result of the recent influx of refugees. This is said to have constrained the divestment possibilities for housing associations, as they play an important role in arranging for housing solutions for this group.

II RECENT MARKET ACTIVITY

i M&A transactions

In January 2015, France's Klépierre SA acquired Dutch-listed real estate company Corio NV through an all-stock €7.2 billion recommended public offer. Corio's portfolio consisted of 57 shopping centres in seven countries across Europe. Through the acquisition of Corio, Klépierre became the second-largest listed real estate company in Europe. As part of the transaction, Corio and Klépierre agreed on a 'pre-wired' cross-border legal merger – the first of its kind in the Netherlands. The merger would be implemented if the 95 per cent threshold for the Dutch statutory squeeze-out procedure was not reached. In return, Klépierre agreed to lower the acceptance threshold of the offer to 80 per cent if the Corio shareholders approved

4 www.cfv.nl/financieel_toezicht/de_corporatiesector_in_cijfers.

the cross-border merger of Corio into Klépierre. The pre-wiring of the merger added deal certainty for the bidder and was an interesting new feature of the transaction. It is also a clear example of a style of M&A dealing in a real estate context. Ultimately, Klépierre did not obtain 95 per cent of the Corio shares and the cross-border merger was implemented without any shareholder opposition in April 2015, showing the effectiveness of this pre-wired legal restructuring.

Only a month later, in May 2015, Klépierre divested nine shopping centres formerly pertaining to the Corio portfolio. In an asset deal, these shopping centres were purchased by Wereldhave NV, a Dutch-listed real estate company, for €730 million. Wereldhave is active in Europe and its portfolio mainly consists of shopping centres.

In July 2014, Dutch housing association Vestia and German fund Patrizia Immobilien AG agreed on the sale by Vestia to Patrizia of a residential portfolio consisting of about 5,500 residential properties for €578 million. A second tranche comprising over 1,000 properties followed in 2016 for an additional €97 million. Vestia had lost billions of euros on its derivatives portfolio during the financial crisis and had to sell a substantial part of its portfolio to recover its losses. This transaction was the first of its kind after the changes in legislation that made the sale by housing associations of large parts of their portfolios to commercial parties possible. Various parties, including some of the municipalities where the properties are located, contested the government's decision to approve the transaction. Administrative proceedings are still pending.

One owner-occupier deal stands out: in 2012 Dutch-listed Royal Philips sold its High Tech Campus business park in Eindhoven, which had become home to about 100 different other technology-related companies in addition to Philips and to a total of 8,000 employees. The buyer was a consortium led by a private investor. The deal value was said to be around €425 million. The deal is considered an early example of a more modern and sophisticated approach in real estate transactions.

ii Private equity transactions

In November 2014, four months after the *Vestia/Patrizia* deal, UK private equity firm Round Hill Capital was the second foreign investor to acquire a large portfolio of residential properties from a Dutch housing association. Round Hill purchased the portfolio, which consisted of 3,786 houses, from Wooninvesteringsfonds for €365 million. Like Vestia, Wooninvesteringsfonds was in financial turmoil and had to divest a significant part of its portfolio to strengthen its financial position. Round Hill is still expanding its Dutch residential portfolio.

Dutch municipalities often impose certain socially motivated restrictions and obligations on housing associations, such as limits on rent levels and priority for certain target groups when housing becomes available. In the deal between Round Hill and Wooninvesteringsfonds, Wooninvesteringsfonds required Round Hill to commit to certain of those restrictions and obligations with regard to the relevant municipalities. This is considered an important precedent for future transactions between housing associations and (foreign) investors.

In July 2014, US private equity firm Lone Star Funds purchased a portfolio of 32 office buildings in the Netherlands from CBRE Global Investors' Dutch Office Fund. The deal value was €372 million. Some of the portfolio's assets had high vacancy levels.

During 2012–2013, US private equity firm Blackstone purchased distressed loans from various banks to Multi Corporation BV, a Dutch company that develops, manages and owns shopping centres across Europe. In September 2013, Blackstone announced that it had completed the acquisition of Multi. Transaction details were not disclosed. After the transaction, Blackstone has made Multi its platform for its retail portfolio in Europe. In 2014, Blackstone acquired 14 shopping centres in the Netherlands from CBRE Global Investors for €240 million and added them to the Multi platform.

There has also been quite some private equity activity in the field of non-performing loans (NPLs); for example, Cerberus buying approximately €400 million of NPLs from Van Lanschot Bank (2015) and Attestor Capital buying €250 of NPLs from FGH Bank (2015). It was recently announced that Lone Star and JPMorgan would be buying bad bank Propertize (with a reported portfolio of €5.5 billion of NPLs) for €895 million. At the time of writing, this is still subject to certain conditions.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

There are four listed REITs or REOCs based in the Netherlands: Wereldhave, Eurocommercial Properties, Vastned Retail and NSI. Unibail-Rodamco is based and listed in France but is also listed in the Netherlands.

Publicly traded structures typically take the form of a public limited liability company (NV) listed on Euronext Amsterdam Stock Exchange. NVs usually are closed-ended (i.e., have no legal obligation to redeem shares) and have an indefinite term. They are internally managed, meaning they employ the individuals that manage the portfolio. They qualify as fiscal investment institutions that are zero-rated for corporate income tax. They are obliged to make annual profit distributions; within eight months of the end of the financial year they have to distribute their taxable profit to their shareholders, provided that certain capital gains are not deemed part of the taxable profit and may be allocated to a reserve. As a result only ordinary income is typically distributed. A fiscal investment institution may only make passive portfolio investments, which typically exclude development or significant redevelopment activities. Development or redevelopment activities by ordinarily taxed subsidiaries of a fiscal investment institution are possible, subject to certain restrictions.

In the Netherlands these structures do not qualify as 'alternative investment funds' for regulatory purposes and are therefore not subject to authorisation by the Netherlands Financial Markets Authority.

ii Real estate PE firms – footprint and structure

In recent years, there has been an increase in real estate investments in the Netherlands by major US and UK private equity firms and other investment funds. Many of them invest in distressed commercial real estate assets or loans.

The key challenges private equity firms face from a tax-structuring perspective are the risk of challenges of the deductibility of interest on intragroup debt, mitigating dividend withholding tax, and structuring acquisitions and exit strategies in respect of distressed loan portfolios in a way that does not trigger Dutch real estate transfer tax (RETT).

There are significant active private real estate investment funds with mainly institutional investors and, to some extent, family firms and wealthy individuals. These funds usually take more of a long-term view than typical private equity firms. Wealthy individual investors also play an important role in the residential sector and have bought significant portfolios over the years from institutional investors.

IV TRANSACTIONS

i Legal frameworks and deal structures

The Netherlands is a civil law country with a mature and well-established legal market. About five law firms are active in the upper part of the real estate market, with differing market shares but without any of them dominating the market. Within these firms, in most cases the lawyers advising on and implementing real estate deals are partners, who are also civil law notaries. In the Netherlands both asset and share transactions require Dutch notarial deeds of transfer. In a typical deal, funds flow through a notary's escrow account and the notary safeguards proper completion of the deal.

As a result of the general quality of the parties active at the high end of the market, the integrity of advisers, the mandatory involvement of civil law notaries, an effective and reliable land register system and a modern civil code, real estate transactions in the Netherlands are generally not surrounded by legal uncertainty.

Evolution of the sale process

Many institutional investors disposed of all or large parts of their direct real estate portfolios in the years between 1998 and 2008. A typical sale process was structured as a one-round tender: a bid book or data room was made available, a single meeting was organised for all bidders involved to ask questions and a week later, in a session normally lasting an hour, all bids (fully binding and without any conditions precedent – not even for financing) were handed in. In those years, the results of auctions were often beyond sellers' expectations. An execution copy of the sale and purchase agreement was provided upfront and had to be submitted with the bid, signed for approval. Only title warranties were provided.

Since 2008, the typical sale process became much more similar to a customary M&A auction process, with multiple rounds to submit offers (often non-binding) the ability to provide a mark-up of the auction draft, confirmatory due diligence by one or two remaining bidders, and ending with negotiations leading to a balanced final contract.

Deal structures

The *Klépierre/Corio* cross-border merger deal stands out. In general, sophisticated structures in real estate transactions cannot be considered common. Most deals still take place in the form of straightforward asset transactions, although share deals do occur more often than before.

In portfolio deals, or even deals concerning a single property, it can be convenient to transfer one set of shares rather than a variety of assets, which then require separate contract takeovers; but this is only a real advantage if the target portfolio is already neatly packaged in a target company. Both types of deal require similar due diligence, provided that the purchaser in a share deal wants comfort that the target company has not been used for any other purpose than holding a specific real estate portfolio, or at least has no liabilities related to activities other than that. Also, both real property and shares are transferred by a notarial deed, although a property transfer is only effective after it has been entered in the land registry.

From a tax perspective, there are fundamental differences between an asset deal and a share deal. The key difference relates to the treatment of capital gains realised as a result of the sale. While capital gains realised on an asset deal are taxable unless the seller is (effectively) exempt and result in a step up (or step down) in tax basis for the buyer, capital gains realised on the sale of shares are exempt while the target company that holds the real estate objects in principle maintains the (lower) tax book value. In share deals, Dutch anti-loss trafficking rules need specific attention: these rules may result in a forfeiture of tax losses as a result of the change of control. Finally, asset and share deals may be treated differently for Dutch RETT purposes. While asset deals are in principle subject to RETT, share deals are only subject to RETT if the buyer, together with related parties, acquires or extends an interest of at least one-third.

Sale of REITs: deal origination

Public REITs being offered for sale is not something that has happened in recent years; rather, there have been recommended bids initiated by strategic buyers. Other than *Klépierre/Corio*, an example – although somewhat less recent – is the acquisition of Rodamco Europe by Unibail in June 2007 to become Europe's biggest real estate company. After the successful tender offer, Unibail Holding SA changed its name to Unibail-Rodamco SA, and was later converted into a European public company (*Societas Europaea* or *SE*).

Parties considering the takeover of a Dutch-listed company should take into account that fiduciary duties of board members of companies in the Netherlands are not only considered as obligations to the shareholders but, more broadly, to the company as a whole. Maximising sale proceeds at the expense of employees or putting continuation at risk may be considered a reason for a management or a supervisory board to use its weight against an unfriendly deal or at least not to cooperate.

A private REIT usually sets its time horizon for a specific date. When that time comes, the remaining participations may be redeemed or the manager may sell off the assets and distribute the proceeds. There are recent examples of participants in some funds teaming up and triggering the sale of such funds, through the sale of either assets or shares. Terms of limited partnerships may allow for such sales if a certain qualified majority approves the deal. They are often prepared by shareholders' or participants' committees running the deal and agreeing upfront with all sellers the terms of engagement, defining the range of acceptable prices and committing them to vote for a deal at a certain price level. When such REITs are in the form of an NV, traditional pre-emptive rights of non-selling shareholders are creatively dealt with by amending the company's articles, and squeezing out any potential remaining minority often takes place using mechanisms well known in the public M&A practice.

ii Acquisition agreement terms

Customary terms for asset deals were more or less clear up until five to seven years ago. The top law firms had developed their own templates, but these were often in line with templates provided by the Royal Dutch Association of Civil Law Notaries; the use of those templates is very common. Such agreements were generally 10 to 20 pages long, with warranties and details on closing included within the body of the contract. A balanced set of warranties would normally be provided, assuming a decent level of due diligence by the purchaser and fair disclosure by the seller, taking into account that a seller's obligation to disclose relevant facts under Dutch law generally outweighs a purchaser's obligation to investigate. Limitations of liability in the form of time limitations deviating from the statutory regime and liability caps were not common.

This has changed to a certain extent. Gradually, a handful of typical M&A clauses have found their way in real estate deals. Specifically, defined limitations of liability and disclosure mechanisms are now common, but break fees, feasibility periods and material adverse change clauses are still absent in most deals.

This situation appears to be subject to ongoing development. Quite often, deal structures in which templates for asset deals are, with minimal changes, used for share deals that are perceived as real estate transactions; conversely, typical share transfer forms are sometimes used for asset deals to achieve a more sophisticated level of contracting. Frequently, it is easy to tell from a contract that the parties to, and perhaps even the lawyers involved in, a share deal have tried to recreate the older, more well-known format and customs of traditional asset deals.

In the Dutch legal context, principles of reasonableness and fairness play an important role. There is no 'four corners of the contract' doctrine. Those principles may, in specific circumstances, even lead to the conclusion that in the absence of an executed contract, the parties are bound to continue negotiations until signing has been achieved. To avoid that as much as possible, parties should clearly define the precontractual stage of their discussions and should emphasise that all negotiations are 'subject to contract'.

iii Hostile transactions

Hostile takeover attempts of Dutch-listed real estate companies are sometimes considered, but not often attempted. One of the few examples dates back to 2001, when Australian real estate company Westfield tried to acquire Dutch-listed real estate company Rodamco North America. This attempt led to a landmark decision by the Dutch Supreme Court about the acceptability of the use of anti-takeover measures by listed companies. Although the Supreme Court sanctioned the use of certain anti-takeover measures by the management board of Rodamco North America, the takeover was ultimately completed.

That said, a possible reason why hostile takeovers are not often attempted is the fact that Dutch-listed real estate companies are fairly well protected – or at least they used to be. Before the introduction of the Alternative Investment Fund Managers Directive (the AIFMD),[5] the regime applicable to listed real estate funds allowed the management board to decide on share issuances, effectively offering an effective instrument against hostile takeovers. Under the AIFMD this regime has disappeared. Various other anti-takeover mechanisms are still available and, generally, are still very common in Dutch-listed companies; multiple measures in a single company can often be used and – although sometimes contested – the companies generally remain intact. However, not all Dutch-listed real estate funds have implemented such anti-takeover measures.

iv Financing considerations

In general, after some years of reluctance, many lenders are back on the market and credit supply is said to be available. Apart from domestic banks and insurance companies, foreign banks and alternative debt providers have also accessed the market.

Although no statistical data is available, the general impression is that lending in the real estate market by domestic banks is still mostly documented using the lenders' own template formats. Loan Market Association-based documentation is used only to a certain extent, usually in larger deals, syndicated financing and when foreign banks are involved. Larger tickets may involve multiple banks using customary intercreditor arrangements. Typical security rights granted to lenders are rights of mortgage on the properties, pledges on the shares of special purpose vehicles (SPVs) and rental income. Using a single security

5 2011/61/EU.

trustee is common, although in the absence of clarity on the enforceability of common law-type collateral agent structures, parallel debt structures are used, as is the case in other civil law countries. Typically, the security trustee holds only one first-ranking security right, and the ranking among creditors is achieved in the distribution of proceeds provisions.

v Tax considerations

Typically, Dutch real estate investments are made through structures that fall within one of the following three categories: (1) a fiscal investment institution acquiring real estate, (2) one or more Dutch or foreign SPVs, which are (highly) leveraged with bank debt and intragroup debt, acquiring real estate or (3) a tax-transparent Dutch or foreign limited partnership acquiring real estate. The main drivers for choosing the optimal structure are described below.

Dutch corporate income tax

The Netherlands currently levies corporate income tax at a rate of 25 per cent (20 per cent for the first €200,000) on profits from Dutch real estate investments regardless of whether they are held by Dutch or foreign entities. Other important features include the following.

Capital gains on the sale of shares in Dutch real estate companies are not subject to corporate income tax as long as an anti-abuse rule applying to foreign shareholders does not apply – this facilitates exit strategies. Further, interest on external debt and related-party debt is not subject to statutory restrictions on interest deduction. Currently, the arm's-length principle is in practice the only limitation on the level of tax-deductible interest. That may change, for instance, as a result of the EU anti-tax avoidance directive drafts, which provide for a generic earnings-stripping rule. Fiscal investment institutions are effectively exempt from Dutch corporate income tax, but in order to qualify as a fiscal investment institution a list of strict requirements – including shareholder diversification and profit distribution requirements – must be satisfied. Finally, (Dutch) pension funds are important investors in the Dutch real estate market. These funds are fully exempt from Dutch corporate income tax. They usually prefer transparent investment structures because this allows them to benefit from their exemption.

Dutch dividend withholding tax

The Netherlands currently levies dividend withholding tax at a rate of 15 per cent on distributions by companies that are tax resident in the Netherlands. In many structures Dutch dividend withholding tax leakage is restricted or eliminated by exemptions or refunds based on Dutch domestic tax law or tax treaties, or through proper structuring.

Dutch real estate transfer tax

The acquisition of Dutch real estate is in principle subject to Dutch RETT at a rate of 6 per cent for commercial real estate and 2 per cent for residential real estate. If real estate is acquired by a group of at least four unrelated investors, or can be structured as such, while the real estate is held by entities or partnerships the interests of which may be transferred, RETT may be saved. RETT is only due on the acquisition of shares in Dutch real estate company or interests in a partnership holding Dutch real estate if the acquirer, together with its affiliates, acquires or extends an interest of one-third or more. An additional requirement applies for the acquisition of interests in a partnership. In order for such an acquisition to be exempt, the partnership must qualify as an investment fund for the purposes of Dutch regulatory supervision laws.

vi Cross-border complications and solutions

The Netherlands is very open to receiving foreign investors. Generally, no restrictions apply to foreign investments, other than anti-terrorist measures and sanctions.

From a Dutch tax perspective, the key points to note from the perspective of foreign investors are Dutch dividend withholding tax and the deductibility of interest due to low-taxed foreign group companies.

V CORPORATE REAL ESTATE

Dutch corporates often hold their real estate in property companies separated from the operating companies. There have not yet been any REIT spin-offs, but some corporations do monetise their real estate, often through sale and lease-back transactions with investors.

Dutch food retailer C1000 offers a good example. In 2011, three years after having been acquired by CVC Capital Partners Ltd, C1000 sold all six of its logistics facilities to WP Carey & Co for €155 million in a sale and lease-back transaction. This transaction, together with an earlier sale of 56 of its supermarkets to competitor Royal Ahold, allowed CVC to recover a substantial part of the price it paid for C1000 a relatively short time after its acquisition. Another high-profile deal concerns Philips' High Tech Campus in Eindhoven, mentioned earlier. A more recent transaction concerns Delta Lloyd selling a portfolio of 16 office buildings, including its own headquarters, the iconic Mondriaan tower in Amsterdam, to a group of Asian investors led by First Sponsor Group in 2015.

VI OUTLOOK

Overall, investors seem to be confident and capital seems to be available. Many Dutch and foreign banks are said to be fully open to increased lending; however, the general feeling is that the supply of high-quality properties, such as offices in Amsterdam's Zuidas district, and attractive residential portfolios will, in the near future, not meet the demand. That seems to be the biggest hurdle.

Chapter 16

POLAND

Izabela Zielińska-Barłożek, Łukasz Szegda, Michał Nowacki, Michał Wons, Maciej Szewczyk and Marcin Pietkiewicz[1]

I OVERVIEW OF THE MARKET

The Polish real estate market continues to grow and after several years of impressive and steady increase in the value of transactions, it maintains its reputation as the most important real estate market in Central–Eastern Europe (CEE). In 2014, the volume of transactions on the investment market reached €3.1 billion, which constituted 30 per cent of all transactions in CEE.[2] In 2015, the volume of investments exceeded €4 billion placing Poland, again, in the leading position in the region.[3] Constant development of infrastructure, flow of new technologies, expansion of e-commerce and centres for shared services are key factors contributing to this development.

As an example, a brief look at transactions on the office property market shows a considerable number of transactions between investment funds with a total value for 2015 of €1.3 billion (offices only).[4]

Foreign private equity and institutional investors dominate the Polish real estate M&A market. International investment platforms, strong funds investing social security premiums from Germany or the United Kingdom, as well as US-based private equity funds are, thus far, overly strong competitors for Polish private equity. The lack of legal regulations

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2 Colliers, 'Przegląd Rynku Nieruchomości', *Podsumowanie roku 2014*. www.colliers.com/pl-pl/-/media/Files/EMEA/poland/reports/2015/colliers-poland-podsumowanie-roku-2014.pdf.

3 http://europaproperty.com/news/2016/02/central-european-investment-volumes-reach-37-billion-poland-as-the-most-attractive-market-2331.

4 www.rp.pl/Nieruchomosci-komercyjne/301149939-Prawie-rekord-na-rynku-nieruchomosci-komercyjnych.html.

allowing the creation of REITs does not encourage Polish investors. According to various sources, the share of Polish funds in the investment market ranges from 3 to 11 per cent.[5] The tendency, however, is reversing, which corresponds to the fact that local investors managed to accumulate capital in the past decade to enter the market now.

Another significant feature of the Polish real estate M&A market is its growing maturity. In transactions, there is an upward trend of 'earn-out' structures, where the parties share risk and link the final price of a company to enterprise income at the time of closing.[6] Similarly, a fall can be seen in the liability level of sellers for a breach of representations and warranties, which is caused, *inter alia*, by market security and predictability.

To sum up, Poland is the first choice for private equity funds interested in investing in CEE.[7] The country's major assets include not only a highly absorbent domestic market and a fast pace of economic growth, but also a mature real estate market.

2015 was characterised by high activity in the Polish M&A market, which is reflected both in the number and value of transactions, the highest since the financial crisis in 2008. In total, over 220 deals were carried out in Poland in 2015.[8] The same trend continues this year.

II RECENT MARKET ACTIVITY

Poland still lacks relevant legal regulations allowing entities in the form of REITs to operate on the Polish market, although some initiatives were undertaken recently, which should speed up the process of adopting relevant laws.[9]

In 2014, the largest M&A transactions in Poland concerned office properties. The largest acquisition concerned the Rondo 1 office skyscraper (over 64,000 square metres of offices in a 40-storey tower and holder of the first LEED Gold environmental certificate in Europe in the category of existing buildings), which, for a price of approximately €300 million, passed from Blackrock Europe Property Fund II to two investment funds managed by Deutsche Asset & Wealth Management.

Another top transaction was the sale of Plac Unii in Warsaw, one of the largest (40,000 square metres of A-class offices and 15,500 square metres of retail space in a shopping centre) commercial properties with mixed functions recently developed in Warsaw and located at a historic square in the capital. It was acquired by Invesco Real Estate from Liebrech & Wood and BBI Development for €226 million.

The strong position of German investment funds on the market was reinforced in the same year with a purchase of the Metropolitan office building for approximately €190 million. This iconic building was sold by another German investment vehicle, Aberdeen Asset Management Deutschland.

5 *The City*, May 2016, p. 11.

6 CMS European M&A Study 2016. www.cms-cmck.com/CMS-European-MA-Study-2016

7 Private Equity in Poland – Facts and Opinions, report by KPMG, available at https://assets.kpmg.com/content/dam/kpmg/pdf/2016/06/pl-raport-kpmg-rynek-private-equity-w--polsce-2016.pdf.

8 M&A Index Poland – fuzje i przejęcia 2015. http://blog.fordata.pl/ma-index-poland-podsumowanie-roku-2015-i-prognozy-na-2016/

9 For this reason, no distinction is made between REITs and private equity transactions when describing the largest real estate M&A transactions in Poland in the past two years.

The following year, for a change, was dominated by retail property transactions. Certainly, the most important and interesting transaction was the acquisition of 75 per cent of shares in a real estate portfolio from Echo Investment Spółka Akcyjna by one of the biggest REITs from South Africa, Redefine Properties, listed on the stock exchange in Johannesburg. With a total value of approximately €1.2 billion, the transaction was announced as the largest in the history of Polish real estate acquisitions thus far and the largest in CEE in recent years. Most assets were shopping centres and the portfolio included 18 office and retail parks in 11 regional cities.

Also in 2015, a well-known shopping centre in Poznań, Stary Browar, was sold for approximately €290 million by a special purpose vehicle (SPV) controlled by one of the wealthiest Poles, Grażyna Kulczyk. The purchaser again was Deutsche Assets & Wealth Management, through one of its companies.

The third emblematic transaction that took place in 2015, and which is worth mentioning, was the acquisition of the Riviera Shopping Centre, the largest retail park in Gdynia (city on the Baltic coast), comprising over 70,000 square metres of retail space. Mayland RE, the company that developed and managed the shopping centre, retained its management under the new owner. The announced value of the transaction was 1.2 billion zlotys. The property was sold by Fonciere Euris and the new owner is a company from the German group Union Investment Real Estate.[10]

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Certainly, the Polish market needs REITs as vehicles allowing investment in the real property market. It is estimated that approximately 75 per cent of pension funds in the world invest in the REIT formula and that such vehicles constitute 10 per cent of their assets.[11]

In Europe, the first REITs were founded in the late 1960s in the Netherlands. The first CEE country to introduce REITs was Bulgaria in 2004, followed by Lithuania in 2008 and Hungary in 2011.[12] It is definitely time for the largest market in the region to also cater to the need of investors. REITs would give Polish investors considerably easier access to the property market and possibilities to invest on a long-term basis.

Such a need was noted long ago, but only in 2015 was the 'Polish REIT' report released by the Warsaw Stock Exchange (the WSE) in cooperation with leading consulting and law firms.[13] The WSE has assumed a leading role of coordinator of work on preparing a solution to introduce commercial real estate companies in the form of REITs into Polish law. According to its preliminary proposal, a REIT is to be a listed company that manages its real estate portfolio on its own or through a professional firm and that regularly pays a dividend at a level of at least 80 per cent of its income. It brings REITs closer to life, but specific

10 All transactions were described on the basis of information published on www.propertynews.pl, www.pb.pl and www.eurobuildcee.com.

11 The City. Magazyn Nieruchomości Komercyjnych, 'Polish funds still waiting for REITs' (May 2016), pp. 12–13.

12 'REIT czyli wielka szansa dla rynku' at www.parkiet.com/artykul/1432860.html.

13 Ibidem.

legal regulations have not yet been implemented or even drafted. The Urban Land Institute Polska estimates that Polish REITs could appear on the market within the next two years[14] depending on the speed of legislation.

ii Real estate PE firms – footprint and structure

The Polish real estate investment fund market is diffused and different sized players can be found. At the top level are companies such as Griffin Real Estate managing funds with investments in all major Polish cities and having shopping centres, offices, and a student hostel chain (Student Depot) in their portfolio, as well as undeveloped properties treated as a 'land bank'. At the other end of the scale are small investors, often individuals, who join forces through SPVs to acquire undeveloped property and sell it after its development (or redevelopment) and when space is fully leased. It is worth noting that companies like Griffin, apart from investing their own resources, also very often provide management services for assets of global investment funds.

IV TRANSACTIONS

i Legal frameworks and deal structures

Poland is a civil law jurisdiction and specific regulations that apply to M&A transactions (in general) and M&A real estate transactions (in particular) are stipulated in several legal acts. Although transactions encompassing shares and assets (specifically involving real properties) are very broadly codified in Polish law, the Polish market is very much 'internationalised'. This is not only in terms of the parties involved in transactions, but also with respect to legal instruments and structures actually utilised. This internationalisation of the market means that numerous legal institutions commonly recognised in global transactions (whether originating from common law or continental legal systems) have been implemented in Polish transactional practice.

It is worth mentioning the general legal constraints that actually affect parties' flexibility in adjusting contracts to their individual needs and global market standards.

First of all, as for transactions directly involving real properties, Polish law requires a disposal contract to be concluded in the form of a notarial deed drawn up by a Polish notary public. Accordingly, in the case of share deals involving shareholding in the most popular company type – a limited liability company – although less formalised, notary involvement, however much more limited, is also necessary.

Second, a disposal of real estate cannot be on a conditional basis (see below concerning acquisition agreements terms).

Third, in asset deals as well as share deals (where properties are only indirectly involved) certain legal constraints affect the transferability of a transaction object depending on, for example, the identity of a prospective buyer[15] and the market effect of a transaction (including any competition aspects).

14 www.money.pl/gielda/wiadomosci/artykul/uli-polska-widzi-szanse-na-polskie-reit-nawet,129,0,2007681.html.

15 For example, nationality or country of registered office and, pursuant to a new recent law, occupation, with regard to agricultural land.

One essential issue that distinguishes the two transaction types is the scope of legal protection provided to the buyer by law. In asset deals, an acquirer of real estate, as part of an enterprise or organised part of an enterprise, enjoys protection of the warranty of public reliance on the land and mortgage register. This principle means (subject to certain limitations) that if there is a discrepancy between the legal status of real estate disclosed in a land and mortgage register and its actual legal status, the content of the land and mortgage register will decide in favour of a party that acquired ownership or other right to property in a transaction with the party or entity disclosed in a land and mortgage register as the rightful holder. In other words, even if the seller was not the owner of real property, but was entered in the land and mortgage register as its owner at the time of transfer and there were no other entries or annotations in register entries that could raise doubt of the purchaser, the acquisition will be valid. This naturally does not mean that buyer prudence at the pre-transactional stage should be limited and verification of technical parameters should still be regarded indispensable. However, with regard to the very essence of a transaction – that is, effective acquisition of proper legal title to real estate – it functions as a far-reaching protective measure.

As for direct real estate acquisitions, a significant restriction must be considered, namely the statutory right of pre-emption with respect to real estate under which certain public entities are provided a right of priority to acquire real estate. If a statutory pre-emption right exists, it is necessary for the parties to first conclude an agreement promising to sell the property on the condition that the holder of a pre-emption right does not exercise such right.

In share deals and generally in transactions involving the merger, division or transformation of companies, acquisition of real estate will not be protected by the warranty of public reliance on the land and mortgage register. This is because the subject of a transaction is the shares in a company, and not its assets, including real estate. In the case of a merger, division or transformation of companies, the warranty of reliance does not function because such transaction involves the acquisition of assets as an entirety of rights through universal succession. Therefore, in such transactions due diligence should include an assessment of the correctness of real estate acquisition.

On the other hand, restrictions arising from the statutory right of pre-emption discussed above will not, in general, apply in such transactions.

Finally, since real estate transactions often do not relate to land alone, but often to certain projects designed or contemplated for a given property or partially performed event, it is worth noting a practical and remarkable difference between share and asset deals. In the case of share deals, a buyer practically steps into the shoes of the seller with the acquired company not only holding the real estate in question, but also all applicable administrative decisions concerning real estate development and construction (e.g., a decision on construction terms or a building permit). On the contrary, in asset deals, a buyer only purchases property and such rights and decisions that are directly attributable to the property. All other rights and decisions must be separately transferred to the buyer or otherwise be re-obtained.

ii Acquisition agreement terms

As already outlined, a transfer of title to real estate under Polish law cannot be conditional and, accordingly, all prerequisites, conditions precedent and the like must be met by the time of conclusion of a final contract that effectively transfers legal title to real estate. However, this does not the preclude parties' right to structure relevant deals in a manner assuring that any applicable conditions to a successful transaction or other covenants are, in fact, fulfilled at the time of title transfer.

In the Polish legal framework, such conditions encompass not only purely business matters (such as furnishing a property in an agreed upon manner) or acquiring any necessary contractors' consents (e.g., for a transfer of contracts related to the property – which is of specific importance if the property itself is a shopping or office centre), but specifically all relevant administrative consents and approvals. The latter group particularly relates to the receipt of a merger clearance (if a transaction itself affects or may affect competition) and acquisition permits for the acquisition of real properties by foreigners within the meaning of a relevant Polish law. Such investors (deemed foreigners), as a rule, must obtain an acquisition permit issued by the Ministry of Internal Affairs and Administration. There are numerous exceptions to this rule, in particular, for foreigners from the EEA or Switzerland. However, if a permit must be obtained, it affects the structure of a transaction, as the transfer of title to real property without a permit is invalid. Usually, the parties conclude a preliminary conditional sale agreement in which a condition precedent for closing is receipt of an acquisition permit.

There are also specific far-reaching restrictions related to the sale of agricultural land. Generally, since 30 April 2016, only an individual farmer can purchase agricultural land barring the exceptions set out in relevant law. The agricultural property market is also protected in the case of a sale of shares in a company being an owner or perpetual usufructuary of agricultural property – in such case a state agency has a statutory pre-emption right to shares. These regulations apply to agricultural properties exceeding an area of 0.3 hectares.

The aforesaid legal constraints pertaining to conditional transfer of real properties practically mean that as long as parties to a contract wish to make it conditional on something, they must divide a transaction into two parts. First, a preliminary or obliging contract is signed. Each of the two legal types of such contracts, although having different practical consequences, generally creates the parties' firm obligation to finalise a transaction by signing, respectively, a final or transfer contract once relevant conditions are met.

Although Polish law includes a rather complex regulation regarding seller liability and corresponding rights of a buyer, these matters are always an issue of the utmost importance when negotiating contracts. Polish law contracts – specifically contracts concluded between entrepreneurs (who by nature usually are parties to real estate transactions that are of our interest in this publication) – may stipulate certain deviations from statutory terms. Such deviations mainly refer to the issue of seller liability, its scope and the time within which a buyer may raise claims under a contract. Therefore, it is common market practice to exclude the application of a statutory warranty in full or in part and to contractually agree on liability mechanics applicable to transaction parties. Such contractual structuring of liability usually signifies its limitation, for example, to circumstances covered by relevant representations and warranties or specific indemnities, and with an exclusion of respectively disclosed matters. Furthermore, transactional contracts usually provide for liability thresholds and limit the time during which the parties may effectively raise claims under contracts. It is worth noting that while contractual freedom in the discussed area is quite extensive, it is anyhow subject to certain limitations that generally encompass fraudulent actions or other forms of wilful misconduct that cannot serve to exclude or limit a given party's (usually the seller's) liability.

iii Hostile transactions

The Polish capital market does not provide many examples of companies listed on the WSE that have fallen victim to a successful hostile takeover. It is also difficult to indicate any hostile takeover transactions with regard to real estate companies.

The specific situation in the real estate transactions market means that experts do not perceive it as being particularly exposed in terms of hostile takeovers. It is possible that more investors will seek opportunities for such acquisitions in Poland in the coming years because of improved prospects and higher profit margins than in western Europe or the United States,[16] but this will most probably affect other businesses (e.g., natural resources mining, pharmaceutical or IT sectors) where it is easier to underestimate the price of shares than in a publicly traded real estate companies.

Hostile takeovers of listed companies fall within the general rules relating to acquisitions of companies listed on the stock exchange in Poland, which implement the EU Takeovers Directive.[17]

A very important aspect of hostile takeovers is the measures made available to the management board in a takeover attempt, as well as ways to protect a company against such takeover. In Polish legal reality, preventive defence measures come to the fore and are quite commonly used by Polish listed companies. They are designed to deter a purchaser from attempting to acquire control by making a company less attractive legally or economically, or by significantly impeding or preventing its takeover against the will of the management board. These measures stem from the organisational structure of a company formed in statutes by its shareholders. Most are introduced well in advance, even at the stage of a company only planning its IPO. Most popular among these measures are restrictions on disposal of shares, the introduction of voting preference shares, restrictions on voting rights on a specific holding (e.g., 10 per cent) and rights personally granted to a shareholder, for example, to appoint management or supervisory board members.

Polish legislation does not provide for an automatic exclusion or limitation of the effectiveness of preventive measures to defend against takeovers (i.e., the breakthrough principle) and does not restrict defensive actions that may be taken by a management board in the face of an attempted hostile takeover (i.e., the neutrality principle) by putting these decisions into the hands of shareholders. That said, companies themselves may introduce such principles by including relevant provisions in their statutes and making the management board responsible for compliance towards shareholders. However, companies very rarely decide to adopt these solutions in their statutes.

The lack of automatic application of the breakthrough principle causes a situation where means of defence provided in company statutes may, in practice, prevent the takeover of a listed company. This is particularly important for those shareholders whose holding of approximately 30 per cent of share capital secures *de facto* control over a company through relevant statutory provisions.

iv Financing considerations

Typical sources of financing for real estate transactions in Poland, in addition to sponsor equity, include bank loans, leasing and bond issuance. There has been a limited number of larger transactions (acquisition of a large real estate portfolios) financed by consortia of

16 www.obserwatorfinansowy.pl/tematyka/rynki-finansowe/prob-wrogich-przejec-bedzie-w-polsce-coraz-wiecej/.

17 2004/25/EC.

senior and mezzanine lenders (including sovereign funds). Some acquisitions are financed or co-financed by international funds (for instance, the acquisition of Echo Investment, a local developer, by Griffin was co-financed by Oaktree Capital and PIMCO).

A number of real estate companies benefit from the status of a listed company to collect funds on the public market. The introduction of a REIT regime in Poland is expected to create a new promising source of financing in the near future.

Equity may have the form of a loan, bond issuance, promissory notes or share capital increase, 'additional contributions'.

As for traditional bank lending, this source of funding is very easily accessible. In addition to Polish general and mortgage banks, foreign banks are also very active on the Polish market, especially German and Austrian ones. This is particularly visible in the investment loan segment. Their lending activity on the Polish market has been increasing recently as the result of a number of local factors negatively affecting the competitiveness of Polish banks, including a newly imposed banking tax.

There is a broad selection of banks competing against each other in the cost of financing, available leverage and tenor and other specific conditions (e.g., required pre-let level, or scope of required sponsor support). Bank financing is widely available not only in Polish currency, but also in foreign currencies (in particular, the euro).

Bonds may be issued either as listed securities or within a private offer. The advantage of bond financing is that it is very often covenant-loose and is less frequently secured with underlying assets.

As regards cross-border financing, its structuring is heavily affected by tax considerations.

On the documentation side, the LMA (Loan Market Association) form of finance documents (adjusted to Polish law) is commonly used by Polish banks. Banking documentation is typically very detailed in listing various types of covenants, including financial, general and information covenants.

As for collateral, banks typically require a mortgage on real estate, security assignment of receivables under lease agreements, insurance policies and, in the case of projects at a development stage, also through key project agreements (such as contracts with a general contractor and architect) as well as a pledge of shares or other equivalent rights of a borrower. All bank accounts are pledged for the benefit of the lender and all equity injected into a project is subordinated. In order to secure continuity of debt service in the case of incidental problems with debt service, security deposits are often required.

Although a mortgage in Poland is effective only upon its registration (which may take several weeks to several months depending on the court), it is a market standard that banks accept only a filing for such registration as a sufficient condition precedent for utilisation of a loan without a need to wait.

Financing structure and a typical timetable may differ depending on whether a financed transaction is a share or asset deal. In the case of an asset deal, due to the noted prohibition on conditionality of real estate acquisition transactions, escrow accounts are often set up to secure safe transfer of the purchase price. Funds are released from such escrow once the property is transferred and a mortgage is established for the benefit of the lenders financing a transaction.

v Tax considerations

Among the different transaction structures outlined above, asset deals prevail in practice in the case of real estate transactions, mainly for tax reasons.

As regards income tax, in the case of an asset deal a step-up of the tax value of real estate can be achieved. From the seller's perspective, income tax of 19 per cent applies as a rule. However, if the ultimate seller is a Polish investment fund controlling real estate through a partnership, a transaction does not elicit income tax (an income tax exemption applies).

As for transactional taxes, in the case of an asset deal the parties usually opt for VAT taxation. In such case, VAT is paid by the seller and is recovered by the buyer. Opting for VAT taxation excludes a transaction from 2 per cent transfer tax (civil law transaction tax), which is less favourable because it constitutes an additional transaction cost for the buyer. Opting for VAT taxation is also often important to the seller because it does not raise the issue of correction of input VAT deductions made by the seller when buying or developing real estate. An asset deal is beyond the scope of VAT and is subject to transfer tax (2 per cent for real estate) if the object of a transaction is classified as a going concern – in the case of a real estate transaction, such transaction object classification rarely occurs.

In the case of share deals, a capital gains tax of 19 per cent applies, unless the seller is protected by a double taxation treaty without a real estate clause (a clause under which capital gains from a disposal of shares in real estate companies can be taxed in Poland).

As a rule, a share deal is not subject to VAT, but instead to transfer tax of 1 per cent due from the buyer (a transfer tax exemption can apply if a company has the form of a joint stock company).

In order to manage tax risks related to a transaction (e.g., the right to opt for VAT or classification of the transaction object as not constituting a going concern), each party can apply for a tax ruling.

On 15 July 2016, a general anti-avoidance rule was introduced into the Polish tax system – this should be taken into account when tax structuring a real estate transaction.

vi Cross-border complications and solutions

Transactions between European real estate investment funds increasingly comprise multi-jurisdictional acquisitions of entire portfolios scattered across several countries.

If such a deal is based on an 'all or nothing' arrangement, it is sometimes very difficult to coordinate the time of simultaneous transfers of title of all real properties. If there are conditions precedent for closing, it is not possible in some jurisdictions (e.g., Poland) to transfer ownership or perpetual usufruct (leasehold) to a property on the condition, thus another notarial deed transferring title will have to be drawn up upon fulfilment of the final condition. Such transactions are therefore structured with rights to withdraw from a contract to enable a party step back from a deal in some jurisdictions if there is a deal-breaker in another jurisdiction. Such a mechanism requires complex unwinding procedures and strict discipline between the parties and other involved entities (legal advises, notary public and financing institutions). Another instrument that can make such a transaction easier to coordinate is a master agreement providing a substantial mechanism for the sequence of events and general payment terms applicable to all jurisdictions, while all individual purchase agreements in a form specific for transfer of real property in each jurisdiction are complementary and are governed by the master agreement to the extent possible under relevant jurisdiction.

If the acquiring party is deemed a foreigner within the meaning of a relevant law and does not originate from the EEA or Switzerland, the transaction must then include a two-step agreement in which the purchaser will have to obtain an acquisition permit from the state authorities during the period between signing and closing (conclusion of a final sale agreement). As a rule, the acquisition permits must first be obtained, even if the purchaser is a company founded under Polish law but is controlled by a foreigner (within the meaning of the relevant law), or if a foreigner intends to purchase a Polish company holding title to real estate and, as a result of the acquisition of shares, the company becomes controlled by a foreigner.

V CORPORATE REAL ESTATE

In terms of the corporate structure of real estate investment funds investing in Poland (funds purchasing already developed office, retail or warehouse premises), there is usually an SPV for each property or at least for each location. Such an approach facilitates the management of projects, distribution of cash flow, control of costs, and liquidation of an SPV once a property is again sold on the market.

An 'opco/propco' structure is also used in a holding structure, albeit not exactly for the purpose of REIT spin-offs, but rather for having a clear division of know-how and management services within a group and allocation of assets to specific property companies, apart from cost optimisation.

VI OUTLOOK

The forecast for the Polish market in the near future is optimistic. The same economic factors will stimulate growth and strengthen its position in the CEE region: the low cost of credit, higher return rates than in western Europe, a stable and mature market, uninterrupted GDP growth, and the development of transport infrastructure.[18] Most investment funds will likely focus more in the next several years on properties in regional cities (Kraków, Łódź, Wrocław, Poznań or the Tri-city). The Polish market follows global or European tendencies where the volume of real estate transactions increases.[19] A specific segment of the market that will be of special interest in the near future is logistic and warehouse properties, as a result of recent legal regulations significantly hindering trade in agricultural land. As a consequence, the value of non-agricultural land within municipal boundaries should increase.

The introduction of REITs will change the manner of activity of funds in Poland and will, no doubt, be the biggest expected change in legal instruments encouraging investment in real estate. Recent years have been dominated by European, in particular, German, funds. Now, there is the increasing presence of capital from more distant countries such as the United States, South Africa and Arab oil-financed economies. It is also possible that after Brexit, some funds concentrated until now in the saturated but very stable UK market will turn their eyes to Poland and other countries in the region.

18 Grupy Doradztwa Nieruchomości w EY – raport at www.ey.com/Publication/vwLUAssets/Broszura_Grupa_Rynku_Nieruchomosci_w_Polsce/$FILE/RE_Broszura_2015_pol_small.pdf.

19 'Global Investor Outlook' report by Colliers, at http://gio.colliers.com/.

Chapter 17

RUSSIA

Andrey Mashkovtsev[1]

I OVERVIEW OF THE MARKET

The Russian real estate market is dominated by private companies, primarily by development and construction groups, and by financial institutions that accumulated major real estate portfolios during the period of the economic crisis as a result of defaults by their borrowers. The state and regions also remain important players, both directly and, in the case of the state, via major state-controlled banks.

Public real estate companies do not exist, and while some financial institutions – significant holders of real estate – are technically public, this does not have any considerable impact on the industry.

There is also a clear preference for certain types of real estate investments exhibited by Russian and international investors. Residential real estate is nearly exclusively the domain of domestic businesses while international players focus on specific types of commercial real estate, such as warehouses and business centres.

Investments in Russian real estate are characterised by the extremely high concentration in Moscow and its satellite towns, with Saint Petersburg a distant second. In the first half of 2016 the share of Moscow in total amount of real estate investments was approximately 82 per cent, and Saint Petersburg approximately 6 per cent.[2]

There is no evident trend in Russia for the real estate industry to be moving from traditional models towards stock markets, and the key players in the area remain private. At the same time, for a number of reasons, M&A and stock market tools are often used in transactions and corporate structuring exercises involving Russian real estate. Additionally, as

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2 www.jll.ru/russia/ru-ru/исследования/201/обзор-рынка-инвестиций-в-недвижимость-россии-за-2-кв-2016.

real estate and real estate development are heavily regulated areas, these industry regulations considerably affect traditional M&A processes when real estate industry players are themselves the targets of M&A transactions.

II RECENT MARKET ACTIVITY

Practically speaking, there is little real difference between 'public' M&A and private equity transactions where Russian players and Russian targets are concerned, even when Russian public companies are involved. This is even more pronounced in the case of real estate industry players, which almost universally are private companies. Consequently, the reporting of the details of the transactions in the industry is generally limited and most deal data remain non-public.

Development and real estate industries were major contributors to the total value of M&A transactions in Russia in 2015[3] and the first quarter of 2016.[4] This was in part due to the biggest Russian M&A deal of 2015, the acquisition of Stroygazconsulting Group, one of the largest construction holdings in Russia, by a consortium of Gazprombank and investment fund United Capital Partners for approximately $7 billion.

Other notable transactions include the acquisition by Yandex of the office space in the Red Rose business centre from KR Properties in the first quarter of 2016 for $680 million and the acquisition by BIN Group in the middle of 2015 of Avgur Estate and A101 Development, holding companies owning 2,400 hectares of land in the territory of New Moscow.[5]

Overall, the proportion of value of M&A transactions attributable to real estate and development industry has shown a threefold increase in 2015 compared with 2014 and represented approximately one-third of the total volume of the market. This trend has lasted into the first quarter of 2016 where the real estate sector continued to be a main contributor. However, this increase took place against the background of the significant drop in the total value of M&A transactions in the Russian market, and the general state of the M&A market remains weak.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

Russian counterparts to REITs – real estate investments funds – can be created in two forms: a joint-stock investment fund and a closed-end unit investment fund.

A joint-stock investment fund is a legal entity created in the form of joint-stock company with the sole purpose of making investments into a specific class of assets (which may include real estate).

A closed-end unit investment fund is not a separate legal entity, but rather a ring-fenced pool of assets that has to meet certain criteria placed by settlors of the trust

3 www.akm.ru/rus/ma/stat/2015/12.htm.
4 www.akm.ru/rus/ma/stat/2016/04.htm.
5 New Moscow is an administrative project extending the Moscow territory at the expense of the area of the Moscow region (Moscow and the Moscow region are different constituent entities of the Russian Federation).

under the management of a trustee, a management company that has a special licence to carry out such activities. The term 'trust' in that context refers to a special type of contract for the management of assets under Russian law, which despite certain similarities is still quite different from a common law trust.

Joint-stock investment funds essentially exist on paper and only a very limited number were ever created. Closed-end unit investment funds, especially those created for the purpose of investments in real estate, on the other hand, found a wider use in the market. Such closed-end unit investment funds of real estate for simplicity will be referred hereafter as REITs. This is the most widespread type of unit investment funds in Russia.

Shares of a joint-stock investment fund may be admitted to public trading on stock exchanges subject to the fund being incorporated as a public joint-stock company and passing the listing requirement of an exchange. Given the rarity of the form itself, presently this remains a theoretical option.

Participation units in REITs also may be admitted to public trading if the rules of trust management of a REIT allow for the possibility of exchange trading in its participation units.

While the option to list REITs is used by fund managers relatively frequently, REITs are seldom created with the purpose of public trading in mind. The main drivers for the creation of REITs are taxation benefits and the ability to ring-fence the real estate property of the founders and avoid disclosure of the owners' identities.

Typical investments by REITs in Russia are focused on such types of properties as shopping centres, office buildings and warehouse complexes in the area of commercial real estate, and new residential complexes. REITs are often used by their founders as vehicles for separate development projects.

Joint-stock investments funds are created by the incorporation of a new joint-stock company in accordance with standard procedure for the registration of a new legal entity. However, a number of additional restrictions are imposed on such companies, for example, not being allowed to issue preferred shares and not having as shareholders the registrar of shares, or a securities depository, auditor or independent appraiser who has entered into a contract for provision of its respective services to such funds. The property of a joint-stock investment fund is split between the property necessary for the functioning of the management of the company and investment reserves that have to be put in the trust of the licensed management company. Payments related to the operations of the assets of joint-stock investments funds have to be carried out via a special separate bank account of the trustee.

REITs are created by the transfer of property into the trust of the licensed management company based on the rules of trust management for the respective REIT previously registered by the management company. The period between registration of the rules and formation of the property complex of the REIT may not exceed six months.

Composition of assets of joint-stock investments funds and REITs should comply with certain requirements. Assets of investment funds investing in real estate may include:

a cash;

b real estate and lease rights in relation to real estate;

c property rights arising out of agreements on participation in shared construction funding (see Section IV.i, *infra*);

d debt instruments;

e participation units of other REITs or rental REIT funds; and

f certain types of shares and participation units of foreign investment trusts (funds).

In addition, the assets of investment funds, shares (participation interest) that can be acquired only by qualified investors may include:

a property rights of investors and developers related to the creation of real estate;
b property rights arising out of construction and EPC contracts related to real estate;
c design documentation; and
d shares or interests in companies involved in designing, engineering and development.

Property encumbered by a pledge cannot be transferred into the assets of a REIT.

In addition, there are certain requirements applicable to the structure of assets of real estate funds, in particular:

a the appraised value of real estate, lease rights in relation to real estate or property rights arising out of agreements on participation in shared construction funding that form the assets of the fund should comprise at least 40 per cent of value of net assets of the fund for at least two-thirds of the total number of business days within a calendar year;
b the appraised value of participation units of other funds forming the assets of the fund should comprise no more than 20 per cent of value of its assets; and
c cash in accounts opened in one credit institution should not exceed 25 per cent of value of the assets.

Properties owned by joint-stock investment funds and properties comprising REITs are accounted for in a specialist depositary whose consent is necessary for the disposal of such assets. Moreover, the rules of trust management of REIT may impose restrictions on the ability of a management company to dispose of real estate comprising a REIT and require that the transactions concerning the REIT property have to be approved by the REIT's investment committee.

ii Real estate PE firms – footprint and structure

There is no significant private equity industry in Russia in the western sense of the term and key private equity investors are a number of western funds that specialise in investments into Russia, but their activities do not leave any specific footprint warranting special analysis.

IV TRANSACTIONS

i Legal frameworks and deal structures

There is a considerable body of legislation in Russia regulating deals with real estate and related rights and investment activities involving real estate. Real estate and related development activities are highly regulated areas in Russia and the transactions happening at the intersection of real estate and M&A might be affected by a wide variety of different legal requirements.

The key law regulating the investment funds is federal law of Russia No. 156-FZ dated 29 November 2001 'On investment funds'. It sets regulatory framework for funds' activities and their relations with investors, and regulates general issues related to the management of the accumulated assets, control over disposal of the assets, obligations of trustees, and audit and disclosure requirements. This law is further supplemented by a significant number of lower-level acts that are mostly adopted by the government of Russia and the Central Bank of Russia.[6] *Inter alia*, the government approves the template rules of trust management for different types of unit investment funds.

M&A transactions in general are still often subject to foreign (primarily English) law, however, there is an evident shift to the wider use of Russian law, especially at the lower end of the market and in mid-sized deals. In part, this results from the major overhaul of Russian civil law, including the law on contracts, which is currently taking place and that now provides tools similar to those envisaged in foreign legal systems. The Civil Code of the Russian Federation is a key authority on both law of contracts and a legal status of real estate. It also defines real estate and sets out necessary terms for transactions concerning real estate.

Structuring considerations for transactions involving real estate are almost always tax-driven. Russian tax law is codified in the Taxation Code of the Russian Federation. Apart from setting general rules for taxation, it specifically regulates the taxation of real estate operations, as well as taxation of the activities of investment funds, including REITs.

There are number of special laws that affect real estate transactions, the most relevant being:

a the Land Code of the Russian Federation, which regulates the use of land, sets restrictions on the use of and transactions concerning land, and contains requirements on land protection;

b federal law of Russia No. 122-FZ dated 21 July 1997 'On state registration of rights in real estate and transactions herewith', which regulates grounds and procedure for the registration of rights, transfers and encumbrances in relation to real estate; and

c federal law of Russia No. 102-FZ dated 16 July 1998 'On mortgage (pledge of real estate)', which regulates the procedure for the conclusion and state registration of mortgage agreements, special requirements relating to foreclosure over real estate, etc.

In addition, there are separate laws dealing with investments in the development of real estate. This includes federal law of Russia No. 39-FZ dated 25 February 1999 'On investment activities in the Russian Federation carried out in the form of the capital expenditures', which regulates investments in fixed capital including expenditures relating to new development, reconstruction and technical refurbishment of existing real estate, and front-end engineering design of development projects.

There is a limited number of stock market instruments in the Russian market that use real estate as a means of investment (the prevalent way to invest in real estate for most of the population is still to buy as many apartments as possible); however, there are certain tools designed to facilitate collective investments into residential real estate.

The key piece of relevant regulation is federal law of Russia No. 214-FZ dated 30 December 2004 'On participation in shared construction funding of apartment housing and other real estate objects'. This law was adopted in order to create a framework for the collective investment by natural persons into the development of residential real estate. Raising funds from natural persons to finance development of future real estate is a very sensitive topic, both politically and socially, because of the long history of related frauds and

6 The latter has exercised regulatory oversight over Russian financial markets since 1 September 2013, when previously independent agency, Federal Financial Markets Service of Russia, became a department of the Central Bank.

developers going bust. As a result, the area of such collective investments is currently heavily regulated. Law No. 214-FZ currently provides for specific types of contracts – agreements on participation in shared construction funding – as means to arrange such investments. It regulates the process of conclusion, performance and termination of relevant agreements, as well as the issues arising from the use of funds raised and required collateral obligations securing the contracts. As previously indicated, rights based on such participation contracts may be included in the assets of real estate investment funds.

Other means of raising funds permitted by Law No. 214-FZ include the issuance of a special type of bond ('residential certificate') by an issuer that owns or leases a land plot and has acquired a building permit for the development of residential real estate at such plot. Such bonds create a right for bond holders to demand the transfer of the residential properties from the issuer. Another permitted option is raising funds via housing saving cooperatives, which was intended for use by communities of residents, but has been adopted in practice by big developers as another way of fundraising.

In terms of M&A activity, the relevance of these regulations is mostly indirect and related to key risks associated with the underlying assets.

It is very common in Russian market to conclude deals with real estate by means of a transfer of shares (participation interests) in the holding company that owns the underlying real estate. This is done for a variety of reasons, including: tax considerations; simpler and more expedient transfer of property title in the case of the sale of equity as compared with asset deals with real estate; and the lack of the need to change existing planning and building permits.

The joint venture toolkit is also sometimes used to regulate the relationship between the owners of spaces in the same real estate property. The operational management of jointly owned properties is exercised by professional service companies, which are selected by the holders of the majority of spaces in the property. While such companies are normally affiliated with the developer of the property or the major owner, it is not unusual for some owners that together hold enough votes to appoint a service company to create the latter as a joint venture.

Transactions involving future real estate can also take other forms besides straightforward assets deals and real estate M&A transaction; for example, they may include co-investment agreements, cooperation agreements and agreements on participation in shared construction funding.

The choice of specific acquisition structure is determined by a variety of factors. These may include:

a the stage of development of the real estate and the grounds on the basis of which the development project is being (or was) realised;
b the nature and intended use of the target real estate;
c the presence of co-owners of spaces in the acquired real estate;
d the status of land rights on the plots occupied by real estate;
e financing arrangements; and
f the preservation of rights for VAT refunds accumulated at development stage.

ii Acquisition agreement terms

The public or private nature of transactions has basically no effect on the structuring and content of acquisition documents. The following outline would generally be applicable in both cases. Typical terms of the acquisition documents for such sort of deals would normally include:

a a detailed description of the real estate being the subject of the transaction, allowing its precise identification by reference to state registration details contained in the Unified State Register of Immoveable Property Rights and Transactions herewith and in the public land cadastre data;
b certain standard representation and warranties;
c the price or procedure for its determination[7] including deferred payments and price-adjustment mechanisms;
d payment and closing arrangements;
e procedure for the effective delivery of the underlying real estate; and
f deal protection mechanisms, including a list of specific breaches and respective sanctions and penalties.

Standard consideration in such transaction is cash. Shares of the acquirer as a consideration would be unusual because, as mentioned earlier, there are no publicly listed industry players in Russia. As such, equity is exchanged (issued) in real estate M&A transactions mostly in joint-venture situations, where liquidity concerns have lower priority.

Typical representations and warranties in an M&A deal at a minimum would cover:

a the legal capacity of the parties and obtaining of the necessary authorisations and corporate approvals;
b title warranties both in relation to the equity being sold and the underlying real estate; and
c the absence of encumbrances and third-party rights, and claims affecting equity and real estate.

Specifically in real estate M&A deals, it is normal for an acquirer to request warranties regarding:

a conformity of the real estate with the declared operational and technical characteristics;
b compliance of the real estate with technical regulations and building rules; and
c compliance with legal and contractual requirements during the development stage of the real estate.

The list is far from exhaustive and additional representation and warranties might be given depending on the specifics of the deal and bargaining power of the parties; for example, warranties related to occupancy rates and the validity and duration of leases with tenants are often encountered in transactions in relation to shopping centres and office buildings.

Typical conditions to closing are similar to any other M&A deal and include:

a all necessary corporate authorisations and approvals being received;
b all regulatory consents (usually related to merger control) being obtained;

7 In the case of asset deals with real estate under Russian law it is a mandatory legal requirement to fix the price or a clear process for its determination in the agreement.

c securing financing when debt financing is envisaged by the terms of the transaction;
d preparation and delivery of standard documentation package in relation to real estate being transferred; and
e for ongoing development projects:
- completion of certain development stages;
- obtaining specific building permits or securing specific land leases with the state; or
- registration of the property title for newly built real property.

Closings are usually carried out on a delivery-versus-payment basis and assume same-day payments and transfer of title to shares.

In terms of deal protections that might be embedded in the contracts as a matter of Russian law, it is usual to have penalty clauses. Penalty clauses are recognised and enforced in Russia and do not have to necessarily correlate with losses incurred by the parties; however, the courts have the authority to lower the amount of penalties at their discretion if they believe them unfair. In the case of high penalty amounts, case law almost universally demonstrates the courts reducing the respective penalties.

In addition, after changes in 2015 to Russian civil law it became possible to agree break-up fees in contracts allowing one party to unilaterally terminate a contract subject to paying the other party a certain pre-agreed amount. As this is a new provision, no case law has yet been formed around it.

Executive compensation matters rarely come into play as there are normally no option programmes, virtual stock options, 'golden parachutes' or other forms of incentive and compensation for the management in situations where an M&A deal is a tool for the transfer of specific real estate. Such matters might become relevant in those M&A transactions that do not serve exclusively as means of real estate transfer, especially involving large and mid-sized industry players.

iii Hostile transactions

There is no practice of US-style hostile takeovers in Russian in general, and while hostile corporate situations in the real estate industry are not uncommon, they happen in private companies and each such situation is usually highly specific.

iv Financing considerations

The key sources of financing in real estate M&A transactions and development projects are the own funds of the industry players and, more significantly, loan financing extended by financial institutions. Development projects are also often partially financed using such collective investment structures as agreements on participation in shared construction funding, co-investment agreements or mechanisms based on REITs. Certain cash flows related to the financing of development projects may be further securitised by financial institutions. Stock markets are almost never used as a source of capital for the industry.

v Tax considerations

As previously mentioned, deals involving real estate are to a considerable extent tax driven. Specifically, there are a number of considerations related to the payment of corporate and personal income taxes.

Transactions involving properties constituting REITs are exempt from income tax. The holder of a participation unit will only pay income tax at the time of repayment or sale of such unit, as well as at the moment of receipt of interim income on the unit. Such deferral of income tax payments allows for full reinvestment of income obtained from transactions involving REIT properties up until the moment the unit holder has actually received the income (the units have been repaid and the interim income has been paid).

At the repayment of participation units, the managing company acting as a tax agent will withhold the amount of tax from the individual shareholder. Corporate entities will pay taxes as per the effective tax rates. Resident shareholders' income will bear personal income tax (at a rate of 13 per cent) and that of legal entities will bear corporate income tax (at a rate of 20 per cent).

Non-resident unit holders' income in the Russian Federation will be taxed at source and will be withheld at the source of income payment (30 per cent for individuals and 20 per cent for corporate entities). Where a foreign company (or individual) is a tax resident of a country party to a double taxation treaty with the Russian Federation, such non-resident shareholders' income will be taxed in the Russian Federation as per the provisions of such treaty.

Transactions involving shares (participation interests) in Russian companies are subject to personal or corporate income tax, where appropriate, at the rates indicated above. Transactions with shares (participation interests) of companies that have been continuously held by the taxpayer for more than five years since the transaction date are exempt from taxation, except for situations where more than 50 per cent of such companies' assets directly or indirectly comprise real properties located within the Russian Federation.

Asset deals with real estate are also taxed at the aforementioned rates. However, Russian individual non-residents' transactions involving real properties are exempt from taxation where the properties have been owned for at least five years (where properties have been obtained in certain ways, for example, as part of a will, this period is reduced to three years).

vi Cross-border complications and solutions

When structuring transactions involving Russian real estate, it is necessary to keep in mind that Russian law prohibits the private ownership of certain type of lands in principle (for example, forests, land reserved for the placement of federal railway infrastructure and natural reserves).

Some of these restrictions are applicable only to foreign persons. For instance, foreign persons are prohibited from owning land plots situated in the territories adjacent to the state borders, included in the list approved by the President of the Russian Federation, land plots within the borders of seaport zones and plots located in agricultural land. Moreover, the restrictions on the foreign ownership of the agricultural lands also apply to Russian companies in which the share of foreign participation exceeds 50 per cent.

Another structuring point to keep in mind is that M&A transactions involving Russian (and in some circumstances offshore) holding companies for real estate might be subject to merger control in Russia and require the consent of federal antitrust service if the assets (or revenue) of the parties to the concentration exceed certain materiality thresholds. Merger control requirements also might be applicable in the case of asset deals if the subject of the transaction is real estate used for industrial purposes.

V CORPORATE REAL ESTATE

Most often, within corporate groups real estate is owned by the entities directly operating such properties (this pattern is most often seen where a group includes several manufacturers carrying out operations and domiciled in various Russian regions). Sometimes, the ownership of real properties used by the companies within a group is concentrated within a single company acting as a holding company for all (or significant part) of the group's real properties, although this is less common. The latter practice might be seen in infrastructure companies and financial lenders optimising the portfolios of their non-core real estate assets.

VI OUTLOOK

Russia is still undergoing a large-scale reform of the civil law, within the framework of which the legal regulation of quite a number of issues relevant to M&A transaction structuring have been amended and revised. Statutory regulation of a large number of important aspects has been brought more closely in line with the needs of businesses, which had previously mostly chosen foreign jurisdictions for M&A deals. Specifically, a number of institutions have been introduced corresponding to popular English law instruments (for example, specific regulation of warranties and representations, indemnity-type arrangements, option clauses in contracts and the right to withdraw from an agreement subject to a payment to the counterparty).

Further amendments to the Civil Code of the Russian Federation dealing with rights *in rem* and certain transaction types, including financial transactions, are expected in the near future. These developments, together with the initial body of case law around previous legal changes are likely to result in a further shift toward the wider use of Russian law in M&A transactions.

In addition, a number of legislative amendments dealing with more specific matters related to investments on the real estate market is being prepared. These include regulations on agency activities on the real estate markets, new rules for advertising related to attracting funds for shared construction funding, and clarification of the rules of technical record-keeping and cadastral valuation of real properties.

In terms of expected economic developments, the situation remains unstable and while the M&A market in general, and the real estate segment in particular, shows certain signs of recovery, it is necessary to keep in mind that some of this growth can be attributed to distressed sales of assets and therefore this trend might be impossible to sustain. Still, there may be some additional localised drivers of growth in the near future, particularly:

a financial institutions being under a certain amount of pressure to dispose of accumulated non-core real estate assets, as holding them for a long time may adversely affect the reservation requirement for banks;

b the upward local driver for the Moscow market may come from the expected approval of the general development plan for New Moscow, which is currently expected to happen at the beginning of 2017; and

c the declared intentions of the Russian government to confiscate unused agricultural land (the amount of which is vast) and auction them at market.

Chapter 18

SPAIN

Yásser-Harbi Mustafá and Ángel Maestro[1]

I OVERVIEW OF THE MARKET

Spain's economic recession redefined the diversity of investors involved in the Spanish real estate sector giving way to various new players entering the Spanish market. These included: (1) the SAREB (Spain's 'bad bank'); (2) financial institutions that took hold of the construction and real estate sectors when the bubble burst, and who accumulated considerable real estate assets and non-performing loans secured by real estate mortgages on their balance sheets as a result of high leverage; and (3) the public sector, addressing the growing need to reduce the public deficit.

All of these continue to offload assets, for which there is no shortage of takers. Credit also appears to be flowing again and new investors are being drawn into the market, significantly increasing real estate transaction volume.

The catalyst for the frenetic real estate activity has been the vast amount of capital pouring into Spain, much of it originating from abroad: opportunity and hedge funds, global investment banks and European fund managers have all entered the fray. Domestic survivors of the Spanish crash have also got back on track and, after a few years of sluggishness, SOCIMIs (listed investment trust companies, or REITs as commonly denominated in Anglo-Saxon economies) are now a reality and the true stars of the real estate sector.

II RECENT MARKET ACTIVITY

i M&A transactions

The Spanish market could be characterised, unlike the Anglo-Saxon real estate markets, as an unsophisticated environment governed implicitly by myriad rules and structures accepted by all players; in recent years, however, new business structures in major M&A transactions, mainly steered by SOCIMIs, have been appearing in the Spanish real estate scene.

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Among such players, the Merlin Properties SOCIMI has played one of the leading roles in the market in recent years. Merlin Properties, which in 2014 was just starting its trading activities in the stock market, has been involved in some of the most discussed transactions in the real estate sector.

In 2015, Merlin acquired the company Testa Inmuebles en Renta, which until that time had been one of the giants of the Spanish real estate sector, for approximately €2 billion, consolidating Merlin's position as the largest SOCIMI in Spain with approximately €5.5 billion in assets. The transaction was carried out through an initial share capital reduction by Testa with a dividend distribution, which allowed the company to repay a credit owed to its former owner, Sacyr Vallehermoso. A capital increase subscribed exclusively by Merlin was then carried out to facilitate the acquisition of 25 per cent of Testa's share capital. The remaining 75 per cent was subsequently acquired in various steps.

Further, in June of this year Merlin announced its merger with Metrovacesa, another giant in the Spanish real estate sector. The parties announced that the transaction would be carried out in three phases.

First, Metrovacesa would be split into three distinct business parts: (1) equity assets with a gross approximate value of €3.2 billion, (2) residential assets, with a gross approximate value of €692 million, and (3) assets under development, considered non-strategic assets, which would fall outside the transaction's perimeter.

In the second stage, the equity portfolio assets would be contributed to Merlin as consideration in exchange for Metrovacesa's shares in the SOCIMI through a share capital increase. Finally, the third step would involve the contribution of the residential portfolio to a company within the Merlin group.

Despite the transaction being subject to approval at the general meetings of both companies (expected to be held in September 2016), there is no doubt that, if completed, it would reinforce Merlin's position as the largest real estate company in Spain.

ii Private equity transactions

In recent years foreign investment funds have been the main participants in large real estate transactions or transactions with an underlying real estate component, such as sales of loan portfolios (both performing and non-performing) or property acquired by Spanish financial institutions through mortgage foreclosures.

These transactions have been characterised by offering international investment funds portfolios of highly discounted assets for the purpose of either clearing the balance sheets of the owners (financial entities), or simply transferring their asset balances prior to their exit from the Spanish market. In this context, two transactions are particularly notable in view of the volume of the acquired portfolio or the quality and complexity of the underlying assets.

First, under 'Project Hercules', with an approximate value of €6.5 billion, Blackstone acquired a portfolio of real estate loans owned by Catalunya Banc at a discount of around 40 per cent. Second – and within this context, perhaps the most-discussed transaction in recent years – came Hypothekenbank Frankfurt's (formerly Eurohypo) sale of its entire loan portfolio in Spain under 'Project Octopus'. Through this sale, Lone Star and JPMorgan acquired a portfolio of top-level financings (either performing or non-performing) valued at around €4.5 billion for an approximate price of €3.5 billion.

It is important to consider that, in the years preceding the crisis, Eurohypo, along with other foreign financial institutions (including Royal Bank of Scotland), had led the grant of funding in large real estate transactions. As such, the loan portfolio was guaranteed with some prime real estate assets in the Spanish market, almost all of which were located in Spain's most populous cities. Therefore, despite the nominal value of the portfolio being less than, for instance, the value of the portfolio acquired by Blackstone in Project Hercules, the complexity of each credit's exposure, the categories of actors involved (representing almost the entire Spanish real estate sector during the pre-crisis years) and, as noted, the prime value of the real estate assets encumbered with mortgages securing these positions made Project Octopus one of the most significant transactions in recent years.

These transactions have acted as a stimulus in Spain's times of crisis and resulted in these funds' decisive entry into the Spanish property market. They are now seeking continuity as opposed to merely specific opportunistic transactions; thus, only a few months after the closing of Project Octopus, Lone Star once again made headlines with 'Project Lion', which involved the acquisition of the real estate platform of Kutxabank, the leading financial institution in the Basque Region (see Section V, *infra*).

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structures and roles in the market

Although the SOCIMI regime dates from 2009, only at the end of 2012 was the law governing the requirements for their creation approved, ushering in a new era for the Spanish real estate market.

SOCIMIs are listed companies whose principal activity is the acquisition, promotion and rehabilitation of urban real estate assets for their leasing, either directly or through equity investments in other REITs. Therefore, these companies focus on active urban properties, excluding specifically exempt categories such as, financial leasing of real estate to third parties, nuclear power plants, wind energy electric generator parks, photovoltaic installations, refineries and airports.

The characteristics of the SOCIMIs can be summarised as follows:

a A SOCIMI is incorporated in the form of a joint stock company (SA);
b The minimum share capital of a SOCIMI is €5 million and it must have at least 50 shareholders.
c A shareholder may own up to 75 per cent of the issued shares, with the remaining 25 per cent subject being floated on the stock market.
d 80 per cent of the asset value must be invested in urban real estate assets leased out, land for development into urban properties for lease (if the development activities start within the three years following the acquisition), and shares in other SOCIMIs, foreign REITs, sub-SOCIMIs or real estate investment funds.

Furthermore, mandatory minimum distributions of profits must be carried out by SOCIMIs in accordance with the following criteria:

a 100 per cent of the dividends received from participating entities;
b 80 per cent of the profit resulting from leasing of real estate and ancillary activities; and
c 50 per cent of the profits resulting from the transfer of properties and shares linked to the company activity, the rest must be reinvested in a three-year period.

Having said this, in order to keep applying the SOCIMI regime, certain investment maintenance requirements must be met. In particular, the participation in other entities as well as the real estate assets must be maintained for a minimum of three years.

The main attraction of the SOCIMI regime is its favorable tax treatment. In this sense, real estate income for SOCIMIs is taxed at a zero corporation tax (CIT) rate (instead of the general rate of 25 per cent), provided that the requirements of the SOCIMI regime are met. In addition, dividends distributed to shareholders whose stake in the share capital of the entity is at least 5 per cent will trigger CIT of 19 per cent on the gross amount, if the dividends are tax exempt or subject to a rate of less than nominal 10 per cent income tax rate in the hands of the relevant shareholder (unless the shareholder is in turn a SOCIMI).

Furthermore, a partial exemption of 20 per cent applies to rents deriving from the lease of residential assets for entities for whom that type of leasing represents more than 50 per cent of their equity. It is also noteworthy that dividends distributed by SOCIMIs are not subject to withholding tax.

Among the most important SOCIMIs in Spain's real estate sector is Merlin Properties, the largest, and also listed on the Ibex 35 (Spain's benchmark stock index consisting of Spain's 35 most liquid companies). Merlin is held by leading international investment funds, including Blackstone, which holds 5 per cent of its share capital. Moreover, should Merlin Properties' projected merger with Metrovacesa bear fruit, the SOCIMI will expand its advantage over all its competitors.

Other well-known SOCIMIs include Hispania, with the backing of George Soros (holding a 16 per cent stake); Lar España, which is focused on shopping centres and holds the distinction of being the first SOCIMI incorporated; and Axiare Patrimonio, whose shareholders include funds such as Citigroup, Deutsche Bank and JPMorgan.

ii Real estate PE firms – footprint and structures

Private equity firms in Spain tend to be characterised by a foreign component, either through direct foreign investment funds operating in Spain or Spanish companies with capital held by foreign entities.

Among the former group, and apart from the investment funds already mentioned (Blackstone, Cerberus, Lone Star, Apollo, etc.), Goldman Sachs has undertaken some intense activity, especially in the latter part of 2015 and the first two quarters of 2016 as reflected in, for example, 'Project Atalaya', which involved the purchase (along with the US fund TPG) of a loan portfolio owned by CaixaBank with a gross value of approximately €800 million.

In any case, the footprint of private equity firms appears to be increasing in the Spanish real estate market with the trend seemingly set to continue. Thus, during the first quarter of 2016, private equity transactions in Spain grew by 164 per cent over the previous year, with the real estate sector being the leading sector.

IV TRANSACTIONS

i Legal frameworks and deal structures

Each investor is different and has its own goals, targets and demands when considering real estate investments. Investments can be executed by acquiring property directly (asset deal) or indirectly by purchasing the share capital of the legal entity owning the real estate (share deal).

Asset deals

Real estate investments are commonly structured as asset deals in which Spanish special purpose vehicles (SPVs) owned by Spanish or a foreign holding companies purchase the assets.

The Spanish SPV's acquisition of a property will be subject to VAT if certain requirements are met (see Section VI.iv, *infra*) and is non-recoverable. The Spanish SPV will be subject to Spanish CIT, generally at a rate of 25 per cent, on its net income (e.g., rental income and capital gains realised on the transfer of a property). Interest (subject to specific limitations under Spanish law), amortisation and expenses are generally deductible if they are linked to the company's business activities and transfer pricing rules are complied with.

Share deals

Share deals were traditionally shunned on the basis that the acquisition of more than 50 per cent of the shares of a company with more than 50 per cent of its assets in real estate was subject to non-recoverable transfer tax (payable by the purchaser) at a rate of between 2 and 11 per cent over the property's market value (depending on the region in which the real estate is located). However, that is no longer the case and under the new draft of Article 314 of Royal Decree 4/2015 of 23 October, approving the revised Securities Market Law, only the transfer of shares that are intended to avoid the payment of taxes applicable on the transfer of real estate will be subject to transfer tax or VAT. In this sense, a legal, rebuttable presumption exists that there is intent to avoid the payment of the indirect taxes applicable to the transfer of real estate in the following circumstances:

a As a consequence of a secondary market transfer of shares, control of a company (defined as an equity stake exceeding 50 per cent) is acquired and the company's assets consist of at least 50 per cent of real estate assets located in Spain that are not linked to a business or professional activity, or if, following the change of control, the purchaser's stake in the company increases.

b As a consequence of a secondary market transfer of shares, control of a company is acquired and the securities forming part of the company's assets lead to control over another entity with assets comprising at least 50 per cent of the real estate assets located in Spain not linked to a business or professional activity, or if, following the change of control, the purchaser's indirect stake in the company increases.

c There is a transfer of shares and the transferred securities are received in exchange for contributions in kind of real estate assets upon the company's incorporation or share capital increase, provided that the real estate assets are not linked to a business or professional activity and no more than three years have elapsed between the contribution date and the transfer date.

As rebuttable presumptions, if any is met, the Spanish tax authorities need not prove an intent to avoid taxes. Conversely, taxpayers are entitled to demonstrate the absence of intent even if the transactions are subject to such presumption. It is worth clarifying that the tax authorities are not precluded from showing the existence of intent to avoid indirect taxes in scenarios other than those covered by these presumptions.

Note that if the transfer of shares is subject to tax (i.e., because the anti-avoidance clause applies), it will be subject to VAT or transfer tax, depending on the tax that would apply to the direct transfer of the real estate assets owned by the company whose shares are being transferred (not always transfer tax, as was the case under the previous regulations).

Divestment

Various exit scenarios exist in terms of divestment.

In an asset deal, the sale of real estate assets would be subject to CIT at a 25 per cent rate on the difference between their market value and their tax basis. The distribution of the proceeds from the Spanish SPV's sale to its Spanish holding company should be exempt from withholdings. Distributions from a Spanish holding company to a foreign investor are subject to a 19 per cent withholding in Spain unless the foreign investor is a tax resident in an EU jurisdiction and the corresponding requirements are met (in which case, the exemption should apply) or if it is tax resident in a country that has ratified a tax treaty for the avoidance of international taxation with Spain and the relevant requirements are met (in which case, reduced withholding rates should apply).

Exit from a share deal involves the disposal of the Spanish SPV's shares. The sale of these shares should not, under certain conditions, trigger indirect taxation for the acquirer or direct taxation for the Spanish holding company since the capital gain realised upon the sale of the Spanish SPV should be exempt from CIT if the corresponding requirements are met at that time. The buyer will, however, inherit embedded taxation and potential contingencies.

Subsequent distributions of the proceeds from the sale of a Spanish holding company to a foreign investor would have the same tax treatment as that outlined for asset deals.

If the sale is executed at the level of the Spanish holding company, the foreign investor will generally be subject to withholding at a 19 per cent rate in accordance with Spanish legislation and tax treaties Spain has ratified.

ii Acquisition agreement terms

As previously mentioned, the Spanish property market has its own idiosyncrasies and structures that may be common in other markets – particularly Anglo-Saxon markets – are not generally common in Spain. The vast majority of real estate transactions fall within the asset deal and share deal umbrella, with one approach being preferred over the other primarily on the basis of the tax benefits of each structure in each specific case. Therefore, regardless of the selected framework, the ultimate result in most cases will involve the exchange of a cash consideration.

Nevertheless, there now appears to be some divergence from traditional approaches, which has generated hybrid figures and alternative solutions that are expanding the range of possibilities for real estate transactions. Interesting payment options are appearing in the market, including the payment of the purchase price by the issuance of shares in the parent company of the buyer's group of companies. It should be understood that, in this case, the issue does not relate to corporate structural modifications such as mergers or splits for the purpose of creating a new company (such as the *Merlín/Metrovacesa* deal referred to above), but is rather about two independent parties who, upon completion of the transaction, will continue to maintain their separate identities. In fact, the idea of offering shares is not intended to force the coalition of the parties, rather to provide a simple solution to liquidity issues.

iii Hostile transactions

The Spanish real estate market's lack of sophistication implies that the possible structures for setting up the conditions and steps of a transaction are highly defined (see Section IV.i *supra*). Thus, the real estate market is predictable for its usual participants.

iv Financing considerations

Having weathered the worst years of the crisis, in which funding and investment was dramatically diminished, a recent surge in credit appears to have taken place, prompted largely by favourable economic prospects.

In this sense, one of the most distinguishing features of the current environment in comparison with the pre-crisis years relates to the identity of the participants in the financing market. As previously discussed, before the crisis, foreign financial institutions had principally provided credit in large real estate transactions; the banking crisis that affected almost the entire eurozone meant that many of those entities, facing highly complex situations in their countries of origin, abandoned the Spanish market. In this context, the main Spanish banks seem to have taken the lead from such foreign entities and are currently involved in almost all financing transactions in Spain's resurgent real estate market.

Current standard market conditions for lending have not significantly changed from those in the past. However, financial entities are increasingly cautious and tend to impose more restrictive conditions on borrowers regarding their capacity to freely dispose of funds prior to the granting of credit. Nevertheless, the main standard market conditions can be summarised as follows:

a interest rates calculated by applying Euribor and a margin of approximately 300 to 350 basis points;

b financing with a loan-to-value ratio of between 50 and 70 per cent;

c the structure of securities being led by a mortgage encumbering the real estate assets with standard mortgage liability representing approximately 130 per cent of the principal credit amount, and additional securities packages mainly consisting of pledges over credit rights, over the SPV shares or pledges over operating bank accounts; and

d hedge agreements covering the risk on interest rate.

v Tax considerations

VAT and transfer tax

As a general rule,[2] the first transfer of non-residential properties by sellers in the course of their business activity is subject to VAT at a rate of 21 per cent; the first transfer of residential properties is subject to VAT at a rate of 10 per cent.

Second and subsequent transfers of built or finished properties by sellers in the course of their business activity are exempt from VAT, and are subject to transfer tax at a rate that ranges between 2 and 11 per cent of their market value (depending on the region in which the property is located and the tax benefits applicable). This VAT exemption can be waived by the parties when the seller and the buyer are VAT registered and the purchaser is entitled to a total or partial VAT credit allowance, and the waiver is expressly made before or by the time the transfer of the property is executed. If the exemption is waived, VAT (rather than non-recoverable transfer tax) will be levied on the transfer.

2 This rule will apply provided that the transfer is not deemed as a transfer of a business as a going concern (TOGC). For VAT purposes, TOGCs are defined as transfers of a business or an independent part of an undertaking that includes the minimum human and material production elements needed for the business or undertaking to operate independently. TOGCs are not subject to VAT but to non-recoverable transfer tax when there are properties involved.

If the VAT exemption is waived, the reverse charge mechanism would apply, and the acquirer of property would be considered to be the VAT taxpayer having the obligations to charge itself the VAT derived from the acquisition and to directly declare the VAT arising from the acquisition of the property (thus generally resulting in a neutral scenario, as output and input VAT will be compensated for in the corresponding VAT return).

Stamp duty

Stamp duty is levied upon execution of a transfer deed if the transfer of real estate is subject to VAT, in which case it will be levied at a rate of between 0.25 and 2 per cent, depending on the region in which the real estate is located; if the transfer is technically subject to VAT and the exemption is waived, stamp duty will be levied at a rate between 0.25 and 2.5 per cent, depending on the autonomous region in which the real estate is located. Stamp duty is paid by the acquirer. It is also paid on many other occasions, including on the creation of mortgages and certain other charges in the Land Registry, at a rate that ranges between 0.25 and 2 per cent.

Other tax considerations to be taken into account

As explained in Section IV.i, *supra*, the chosen structure for a transaction (i.e., asset deal or share deal) will depend on many considerations, such as the nature of the investor and the type of real estate asset to be acquired; therefore, tax concerns should be taken into account on a case-by-case basis once all these considerations are apparent. However, market practice is more favourable to share deals as a result of the amendment of indirect taxation derived from the acquisition of the real estate company's shares.

In this sense, and by way of an example, it is becoming more and more usual that foreign investors opt for the incorporation of a Spanish two-tier investment structure as a consequence of the new participation exemption framework applicable to capital gains realised upon the disposal of shares of subsidiary entities, provided some requirements are met.

vi Cross-border complications and solutions

Apart from the standard money-laundering regulations that apply in Spain as in other European jurisdictions, there are no restrictions or complications for foreign investments.

From a tax standpoint, non-Spanish resident investors should consider any double taxation treaty entered into by and between Spain and their countries of residence in order to avoid or reduce applicable Spanish withholdings on dividends, interest and capital gains. As stated in Section IV.i, *supra*, there are several structures to reduce the Spanish taxation in this kind of transaction.

V CORPORATE REAL ESTATE

As previously mentioned, corporate real estate transactions have in recent years been marked by the entry of international investment funds particularly by way of the sales by Spanish financial institutions of their real estate platforms.

This trend began at the end of 2013 and continued throughout early 2014 with Banco Santander's sale of its Altamira Real Estate platform, with about €8 billion in real estate assets under management, to the Apollo fund in exchange for a consideration of approximately €665 million. Other Spanish banks soon followed, including Banco Popular (selling Aliseda Real Estate to Kennedy Wilson and Varde for approximately €9.3 billion) and CatalunyaCaixa (selling its platform to investment funds managed by Blackstone and Magic).

Following this approach, Lone Star acquired the Neinor group, Kutxabank's real estate platform, for approximately price of €930 million under 'Project Lion'. The transaction was unusual as Lone Star not only acquired the platform but also a 50 per cent stake in the portfolio of real estate assets owned by Kutxabank.

Other Spanish financial institutions have also taken this path, or plan to do so in the near future. However, although it seems that this trend must inevitably end given the limited number of remaining real estate platforms; it nevertheless suggests that the large international private equity funds intend to remain in the Spanish market.

VI OUTLOOK

2016 has been meeting the favourable growth forecasts of the Spanish economy – among the eurozone's highest – with growth forecasts close to 2.7 per cent according to various market sources. These estimates have clearly affected Spain's property market.

Thus, although foreign investment in real estate will not achieve levels similar to those in recent years, the positive trend is predicted to continue (with expected investment of between €8.5 billion and €9.5 billion according to CBRE), with the added value of higher-quality real estate currently available in the market now the discounted sales characterising real estate investment during recent years have ended.

2016 also saw a consolidation of SOCIMIs; more than 40 per cent of the real estate investment in Spain in 2015 derived from SOCIMIs, and it is expected that SOCIMIs will remain the main players in Spanish real estate transactions. This upward trend has also been seen in those sectors hit more heavily during the crisis, such as logistics (especially in Barcelona), retail and residential (being in a period of increasing new housing stock).

In relation to the activity of investment funds and other private equity funds, although the supply of credit portfolios has nearly come to an end, there are some appealing last-minute scraps, such as the portfolio Bankia sought to place on the market in 'Project Big Bang', estimated to be worth approximately €4.8 billion.

It is important to point out, however, that, in contrast to this positive trend in the economic outlook, Spain's current political uncertainty – not only resulting from the lack of a strong central government but also the actions of some of the parties currently governing in important municipalities (especially Madrid and Barcelona) – has been causing concern about the immediate path of future growth. This follows the dispiriting moratorium approved by the municipality of Barcelona, suspending the opening of new tourist accommodation in the city, as well as the municipality of Madrid's blocking of major real estate development transactions, particularly 'Project Chamartín'.

This environment along with other international events, including Brexit and the challenges it poses for the current EU project, will test the true strength of the Spanish economy in the immediate future.

Chapter 19

UNITED KINGDOM

Richard Smith and Chris Smith[1]

I OVERVIEW OF THE MARKET

2014 and 2015 were record-breaking years for real estate M&A in the United Kingdom and saw over £128 billion-worth of completed transactions.[2] The past few years have been marked by a large number of deals in the hotels, leisure and specialist property industries, and investment volumes have been boosted by a number of large portfolio deals, highlighted below, with only a small number of single asset transactions exceeding £300 million.

The increase in portfolio transactions has largely been driven by overseas investors who have continued to demand larger lot sizes. That demand accounted for around half of all acquisitions by deal value in 2015 and also led to an increase in competitive tenders and auction processes. Interestingly, large portfolio acquisitions have not been confined to central London; there has been a much greater diversification and geographical spread in the stock purchased by foreign investors over the past two to three years.

Given the fluctuation and uncertainty in the equities and bonds markets over the past year, real estate has also been considered an attractive and safe asset for many investors. Indeed, returns have outstripped those from equities and bonds, led by the office and industrial sectors (currently in a stronger position than retail), which have seen increased demand and undersupply. While retail development has been limited, there have been pockets of high demand, particularly in London.

The availability of cheap debt finance also continued to increase during the 2014 and 2015 period, with both banks and other financial institutions targeting opportunities to lend across a wide range of sectors. There has been a healthy appetite for, and a higher level of, new

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2 Investment volumes reached £66.3 billion in 2015, compared with £61.7 billion in 2014 (see Lambert Smith Hampton, 'UK Investment Transactions Bulletin Q4 2015' (www.lsh.co.uk/~/media/files/lsh/pdfs/research-reports/ukit/34141-lsh-ukit-q4-2015.ashx)) (accessed 20 June 2016).

loan originations in more secure areas of the market and senior debt and mezzanine finance markets continue to be competitive. Insurers have also stepped into the real estate debt market in larger numbers, increasing pressure on, and competition against, the traditional banks. Consequently, some lenders have also increased their risk appetite, considering lending on secondary assets in prime regional locations (though the availability of development finance has remained limited).

The first half of 2016 has seen a marked slowdown, with activity and deal flow levels dropping in the run-up to the United Kingdom's referendum on its membership of the EU.[3] The vote to leave has disrupted the markets and left many sectors in a state of uncertainty and instability. While activity has by no means ceased, there is a question as to how the real estate sector will behave for the remainder of 2016 and beyond.

II RECENT MARKET ACTIVITY

i M&A transactions

Some of the most significant real estate M&A transactions of the past few years are summarised below.

Digital Realty Trust's acquisition of eight data centres

In May 2016, Digital Realty Trust Inc, the US-based REIT, announced that it had entered into an agreement to acquire a portfolio of eight data centres (in London, Amsterdam and Frankfurt) from Equinix Inc, another US-based REIT, for approximately $874.4 million.

The sale by Equinix was a condition of the clearance from the European Commission for Equinix's acquisition in January 2016 of TelecityGroup plc, the European data centre provider, for $3.8 billion. The acquisition, which disrupted an existing merger between TelecityGroup and Interxion and secured Equinix's position as the top data centre provider in Europe, gave rise to substantive antitrust overlaps and resulted in commitments being given to the European Commission to divest the eight data centres.

As part of the transaction, Digital Realty granted Equinix a binding option to acquire its operating business, including its facility in Paris. Digital Realty saw the deal as an opportunity to enhance its global presence and increase the scale of its European data centre operations.

London & Regional's acquisition of the Atlas Hotels Group

In April 2016, London & Regional, the UK-based property company, acquired Atlas Hotels Group Limited, the UK-based hotel operator, from Lone Star Funds, the US-based private equity firm, for £575 million.

The transaction included 46 Holiday Inn Express hotels and a Hampton by Hilton and was London & Regional's first venture into the budget sector. The portfolio comprised 5,575 rooms, 15 per cent of which were located in London.

3 Investment volumes for the first quarter of 2016 were at £11.9 billion, down 26 per cent on the previous quarter (see Lambert Smith Hampton, 'Uncertainty weighs on London' (www.lsh.co.uk/~/media/files/lsh/pdfs/research-reports/ukit/34244-lsh-ukit-q1-2016-e.ashx)) (accessed 20 June 2016).

Greystar Student Living's purchase of the Nido student accommodation portfolio

In April 2015, Greystar Real Estate Partners (through its subsidiary Greystar Student Living) acquired three student accommodation properties from Nido London, a UK-based student accommodation company, managed by Round Hill Capital, for £600 million.

The portfolio comprised 2,375 beds, spread across three London locations. Greystar saw scope for significant value given the recent growth in the student accommodation industry.

Intu Properties' acquisition of three Westfield Group retail sites

In May 2014, Intu Properties plc, a UK-based retail developer, acquired the Merry Hill, Derby and Sprucefield shopping centres of the Westfield Group, the Australian retail property group, for £863 million.

Intu acquired 50 per cent of Merry Hill, 100 per cent of Derby and 100 per cent of Sprucefield and financed the transaction by way of new debt facilities (totalling £423.8 million) along with a fully underwritten rights issue (raising approximately £488 million).

IPOs

A number of REIT and commercial real estate companies have also listed on the London Stock Exchange in recent years. Some examples are detailed below:

a Schroder European Real Estate Investment Trust plc (a REIT investing in commercial real estate in Europe – listed 9 December 2015): market capitalisation on admission – £107.5 million; size of the offer – £107.5 million.

b AEW UK REIT plc (a REIT investing predominantly in a portfolio of smaller commercial properties in the United Kingdom – listed 12 May 2015): market capitalisation on admission – £100.5 million; size of the offer – £98.5 million.

c Kennedy Wilson Europe Real Estate plc (a company investing in real estate across the United Kingdom, Ireland, Spain and Italy – listed 28 February 2014): market capitalisation on admission – £910 million; size of the offer – £819 million.

ii Private equity transactions

Private equity is also active in the real estate market in the United Kingdom and in recent years, private equity firms have raised significant funds with relative ease. Some of the major private equity real estate M&A transactions over the past few years are summarised below.

Lone Star's acquisition of MRH (GB) Limited

In January 2016, Lone Star Funds, the US-based private firm, acquired MRH (GB) Limited, a UK owner and operator of petrol filling stations, from Equistone Partners Europe Limited, the UK-based private equity firm, and Susan Tobell and Graham Peacock (private individuals) for £1 billion.

The acquisition included 450 petrol stations (mostly branded BP and Esso) and was particularly attractive to Lone Star given MRH had reported revenues of £1.79 billion for the year ended September 2014.

Brookfield's acquisition of Center Parcs UK

In September 2015, Brookfield Property Partners (a subsidiary of Brookfield Asset Management) acquired Center Parcs UK from Blackstone Capital Partners V (a fund managed by the Blackstone Group) for £2.4 billion.

The assets included Center Parcs' five UK holiday parks (which employ around 7,500 people). The transaction was attractive to Brookfield given the target's steady cash flow generation and average occupancy rates of approximately 97 per cent.

Lone Star's purchase of a Jurys Inn hotel portfolio

In March 2015, Lone Star Funds acquired a chain of 31 Jurys Inn hotels from a group of investors, including the Oman Investment Fund, Mount Kellett Capital Management, Ulster Bank, Westmont Hospitality Group and Avestus Capital Partners, for £680 million.

The assets included 7,000 rooms across 31 cities (21 provincial UK hotels, four London hotels, five hotels in Ireland and one in Prague). Lone Star saw the potential for future growth of the business and seized the opportunity to further capitalise in the hotel sector.

Blackstone's acquisition of a portfolio of 16 warehouse properties

In April 2015, Blackstone Real Estate Partners Europe IV acquired 16 UK warehouse properties for its European logistics company, Logicor, from a joint venture between Oaktree Capital Management and Anglesea Capital, for £381 million.

The properties were located in core logistics markets across the United Kingdom and were leased to a diverse range of tenants (including Arcadia, B&Q, Co-Operative Group, Debenhams and Unipart). The transaction substantially increased Logicor's UK portfolio and enhanced its relationships with important customers, strengthening its position in the sector.

Private equity takeovers

In addition to the above private equity M&A transactions, there have also been a number of recent takeovers and mandatory offers by private equity firms in the United Kingdom.

a Brookfield and Qatar Investment Authority (2015) made a mandatory offer, through their joint vehicle Stork Holdco, to acquire a 30.63 per cent stake in Canary Wharf Group plc (CWGP) at an offer price of £6.45 per share, valuing the transaction at £1.26 billion.[4]

b Lone Star Funds (2015) made a voluntary recommended offer to acquire the shares in Quintain Estates & Development plc, the UK-based real estate company, at an offer price of £1.41 per share, valuing the transaction at around £745 million.

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 acquiring or developing property for sale, is taxed at

4 The mandatory offer was triggered as a result of Stork Holdco's acquisition in 2014 of Songbird Estates for £4.8 billion. Songbird owned a 69.3 per cent stake in CWGP, which meant Stork Holdco's acquisition gave rise to the mandatory offer to acquire the remaining shares of CWGP. Following the acquisition, Stork Holdco combined Songbird and CWGP into a single operating entity.

the main corporation tax rate.[5] While not all property companies are REITs by any means, the largest corporate real estate groups are structured as REITs in order 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 in the United Kingdom for tax purposes;

b it can have only one class of ordinary shares, which must be listed or admitted to trading on a recognised stock exchange;[6]

c it must not be a 'close company' (a company that is controlled by five or fewer shareholders); 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 the business to hold at least three properties, each representing no more than 40 per cent of the total value of the portfolio.

In order to ensure that the property income generated by the 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 the 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 the UK REIT 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 the acquisition are such that at least 35 per cent of the ordinary shares remain in public hands. However, UK and foreign REITs are now recognised as 'institutional investors', which should deal with that point in most cases. 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.

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.

5 Currently 20 per cent, set to drop to 19 per cent from 1 April 2017 and then to 17 per cent from 1 April 2020.

6 The official UK list or the official list of another country having a recognised stock exchange.

However, as property prices have recovered, there has been a renewed interest in UK REITs as a tax-efficient investment structure, especially following HMRC's 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.

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 and Hammerson, and the number of UK REITs has grown significantly in recent years (including externally managed UK REITs) to well over 30.

ii 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 (often 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 Partnership 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 per cent 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 raised large amounts of capital for European real estate between 2013 and 2015. This filtered through to the United Kingdom, with investors attracted by a relatively benevolent tax environment and the lack of legal restrictions imposed on overseas investors holding commercial real estate assets. Investment by firms in real estate in central London alone almost doubled between 2007 and 2013, with investment increasing from £350 million to £636 million.[7]

7 See Knight Frank research (2014), highlighted in White and Case's 'Spotlight on London real estate' (http://events.whitecase.com/insights/Insight_SpotlightOnLondonRealEstate.pdf) (accessed 28 June 2016).

As highlighted by the deals outlined above, private equity firms have recently purchased large portions of commercial real estate for the diversification that the assets afford, the protection they offer against inflation and the dual benefits of equity-type performance potential coupled with a bond-type risk profile (due to the steady income from rental receipts and capital growth).[8]

Private equity firms have targeted various real estate assets in recent years, including:

a the hotel market, which has seen increased demand from cash-rich investors from Asia, the Middle East and US-based private equity firms;[9]

b healthcare, with investment seen in healthcare services, social care services, pharmaceuticals and medical tech;[10] and

c student accommodation, driven by emerging-market wealth – global investment into UK student housing saw over £1.45 billion invested into 29,744 beds in 2014 alone.

The value of assets and land traded during the first five months of 2015 was £4.2 billion and the bulk of that investment activity shifted from UK owner-operators to UK and overseas-based private equity and global institutions.[11]

IV TRANSACTIONS

i Legal frameworks and deal structures

Legal framework

When investors acquire or dispose of real estate in the United Kingdom, the majority of such deals do not involve the 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, in each case, on 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;

8 See White & Case, 'London calling: Investing in commercial real estate' (2014) (www.whitecase.com/sites/whitecase/files/files/download/publications/print-London-calling-Investing-in-commercial-real-estate.pdf) (accessed 28 June 2016).

9 See BNP Paribas, 'BNP Paribas Real Estate Guide to Investing in London 2015' (2014) (https://www.realestate.bnpparibas.co.uk/upload/docs/application/pdf/2015-04/investing_in_london_guide_2015_-_bnp_paribas_real_estate_uk.pdf) (accessed 28 June 2016).

10 *Financial Times*, 'Property is one-third of alternative assets' (13 July 2015).

11 See Savills, 'Spotlight: UK Student Housing' (2015) (http://pdf.euro.savills.co.uk/residential---other/spotlight--uk-student-housing-2015.pdf) (accessed 28 June 2016).

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, depending on the structure, to general common law rules, the legislative provisions of company and partnership law and the provisions of the JV agreement;

e trusts of land: any trust that includes land as part of the trust property will be a trust of land. Trustees have a power to sell the property, but no obligation to do so, unless this is made expressly. 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 way to make contractual claims in respect of warranties and post-completion purchase price adjustments.[12]

ii Acquisition agreement terms

As noted, typically real estate assets will change hands through the 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 vendor'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.

12 See *Practical Law*, 'Private mergers and acquisitions in the UK (England and Wales): market analysis overview' (http://uk.practicallaw.com/6-546-2709?source=relatedcontent) (accessed 29 June 2017).

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.[13]

Splits between signing and completion

For any split between signing, several practical matters should be considered:

a whether shareholder (or equivalent) approval is required by either of the parties;
b whether EU merger clearance is required;
c whether any warranties given at signing need to be repeated at completion;
d whether rescission is possible between signing and completion;
e whether any deposit paid at signing should be returned to, or forfeited by, the buyer if the transaction does not complete; and
f whether 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 the buyer is able to negotiate a rescission right, mentioned above, during that time.

Where a seller is 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 such 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 for the buyer (e.g., to procure debt finance), it is less likely it 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 the 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 reliance on certificate of title issued by the vendor's lawyers or through a normal due diligence exercise.

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 in order to provide the buyer 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.

13 *Estates Gazette*, 'Corporate real estate transactions: buyer beware' (7 March 2015).

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 the shares or real estate assets and the capacity and authority of the seller to enter into the 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 consents or permissions) 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 to 20 per cent of the overall consideration).[14]

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 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 is 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.

iii 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;

14 Ibid.

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, cash collateral, and by obtaining floating charges from the parent company.[15]

Where development and construction is anticipated, lenders may also require approval of material development documentation as a condition precedent in order to draw down 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 in order to take over a contract in the event of default.

iv 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. 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. 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, though owners can opt to tax the property at the standard rate of 20 per cent. Generally, most sellers opt to tax. Where a property is let to tenants, 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.

Interest charges on borrowings are 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 deductible.

Currently all borrowing costs are deductible to reduce taxable profit, but changes in April 2017 will limit the amount of deductible interest to 30 per cent of the owner's EBITDA. This restriction is likely to apply equally to UK and non-UK owners.

v Cross-border considerations

Where a foreign investor is proposing to carry out a 'trading' activity in relation to property (including development), historically it has been appropriate to hive off that activity into a

15 See Herbert Smith Freehills, 'A legal guide to investing in the UK for foreign investors' (2012) (www.herbertsmithfreehills.com/-/media/HS/L050712154578912171416219.pdf) (accessed 27 June 2016).

separate entity for tax purposes. Consequently, the typical structure in these circumstances is that the property-holding company is combined with an operating company (usually a non-UK 'propco') to shelter capital gains and a UK 'opco' will carry out the trading activity.[16]

Any development or other services to be carried out will be undertaken by the UK opco and any charges rendered by the opco to the propco should be allowable against the propco's taxable income. In addition, any VAT charged to a propco will be recoverable where the propco has 'opted to tax'.[17]

Under new rules, the non-UK propco may be deemed to have a 'permanent establishment' in the United Kingdom by virtue of its ownership of the development site or property. Consequently, the profits of the propco will become subject to UK corporation tax. The timing of this change is uncertain but any non-UK propco that owns a development site or property in the United Kingdom may well now find itself subject to UK corporation tax on its profits arising from April 2016.[18]

V OUTLOOK

Following the outcome of the EU referendum, the United Kingdom is expected to enter a period of uncertainty and it remains to be seen how the real estate M&A market will behave over the course of the next 12 to 24 months (and in the longer term). Financial and political instability have historically reduced M&A activity substantially.

Many predicted a rise in investment activity throughout the second half of 2016 following a 'remain' vote. The 'leave' vote has caused many investors to pause and wait for clarity. It is likely they will adopt a more cautious approach and reconsider their long-term strategies and, consequently, investment activity may be suppressed for a time.

In London, investment is expected to stall temporarily. A weakened demand for commercial space is forecast, which could push retail and office values down by 15 per cent to 20 per cent over the next 18 months.[19] Consequently, development projects are likely to be suspended as developers re-evaluate their positions. Property prices generally are also expected to drop by 10 to 20 per cent over the same period.[20] Given these forecasts, owners may be unwilling to dispose of good assets, at least in the short term.

Elsewhere in the country, investment is likely to continue given the potential for growth (Manchester and Birmingham have seen high demand from investors in recent years), but at a slower pace. Transaction levels were already muted by a lack of available stock and development finance and that trend is likely to continue, with debt finance potentially more difficult to acquire.

16 See Withers, 'Taxation of investment in UK commercial real estate' (www.withersworldwide.com/news-publications/taxation-of-investment-in-uk-commercial-real-estate--2) (accessed 28 June 2016).

17 Ibid.

18 Ibid.

19 See the *Wall Street Journal*, 'Brexit Vote Roils Real-Estate Markets' (www.wsj.com/articles/brexit-vote-roils-real-estate-markets-1467146797) (accessed 29 June 2016).

20 *Financial Times*, 'Developers rethink London property schemes' (28 June 2016).

Further instability is expected after a number of open-ended funds[21] suspended trading on their real estate funds following withdrawal requests after the Brexit vote, which has affected their liquidity. Other funds continue to monitor redemption requests, but the Bank of England has warned that if the market continues to worsen, commercial real estate companies that use debt to buy property may not be able to access that money. Further, forced sales or falling values could detrimentally affect the ability of property companies to lend money; many are concerned that their lending will become restricted if their activities are deemed more risky.

However, despite the current climate, the UK real estate sector remains attractive – the United Kingdom's well-established legal, tax and planning systems, transparency and lack of corruption means investors continue to see opportunity and consider the United Kingdom a safe jurisdiction in which to operate – and consequently it may become one of the few defensive sectors to prevail, even if the current uncertainty affects deal flow in other sectors. Short-term political uncertainty can create buying opportunities and may result in a boost in the property market as investors deal at slightly deflated prices. Commercial property is also still seen as a 'safe haven' asset. Foreign investors often invest in UK commercial property to escape debt crises or other economic problems at home; leaving the EU is unlikely to change this in the long term.[22] It is also possible that a weaker sterling could attract more investment into the property market. The strength of the pound compared with emerging currencies has in the past tended to make property investments less appealing to some investors. Leaving the EU could reverse this situation.[23]

Finally, it is worth noting that, historically, access to the single market has not been the main driver for real estate investment in the United Kingdom. Consequently, the impact of leaving the EU could be negligible as most foreign capital coming into the UK property market is for investment rather than operational purposes.

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21 Standard Life, Aviva Investors and M&G Investments.

22 See DLA Piper, 'Brexit and the UK commercial property market' (https://www.dlapiper.com/en/uk/insights/publications/2016/06/brexit-and-the-uk-commercial-property-market/) (accessed 28 June 2016).

23 When sterling fell during the financial crisis, many foreign investors turned to the United Kingdom and bought up property in prime central locations at relatively cheap prices.

Chapter 20

UNITED STATES

Adam Emmerich, Robin Panovka and Matthew MacDonald [1]

I OVERVIEW OF THE MARKET

The REIT sector in the United States has expanded dramatically over the past two decades. Until the 'REIT Revolution' of the 1990s, private sources of capital dominated the US commercial real estate industry, and publicly traded real estate vehicles such as REITs played a relatively small role. The tables have now turned, and public REITs are dominant in a number of sectors and show every sign of continuing to grow.

US REITs today own more than $1.8 trillion of commercial real estate, and the industry's equity market capitalisation is close to $1 trillion.[2] There are now over 150 REITs in the United States with a market capitalisation over $1 billion, and 24 of those are over $10 billion.[3] Compare this to 1995, when the entire market capitalisation of the US REIT industry was just $57.5 billion, and there were only six REITs with a market capitalisation over $1 billion.[4]

In addition to growing in size, US REITs have also broadened their reach in terms of asset classes and have begun to expand geographically outside of the United States. While REITs traditionally owned office, multi-family, retail, industrial and lodging assets, today REITs extend across an array of non-traditional sectors, including telecommunications, timber, data storage, outdoor advertising and gaming.

Along with REITs, private equity funds have also become dominant institutional players in US commercial real estate over the past 20 years. At the sector's fundraising peak in

1 Adam Emmerich and Robin Panovka are partners and Matthew MacDonald is an associate at Wachtell, Lipton, Rosen & Katz.
2 NAREIT REITWatch (data as of 31 May 2016).
3 S&P CapitalIQ
4 NAREIT REITWatch

2008, real estate private equity funds raised over $130 billion per annum.[5] While fundraising following the 2008 financial crisis has not yet reached that level, private equity funds have continued to raise large amounts of capital (reaching $117 billion in 2015)[6] and have been the architects of some of the largest recent M&A deals in the real estate sector. While international institutional investors have had exposure to the US real estate sector for many years, sovereign wealth funds and other sources of international capital have demonstrated increased interest in the US real estate sector, including through joint ventures with US-based REITs and private equity funds. Foreign investors conducted $87.3 billion of real estate deals in the United States in 2015, up from less than $5 billion in 2009.[7]

II RECENT MARKET ACTIVITY

i M&A transactions

Recent REIT M&A activity has involved three major types of deals: (1) spin-offs by REITs of elements of their portfolios into newly created REITs; (2) mergers between REITs; and (3) transactions using the REIT structure to unlock the value of corporate-owned real estate.

Spin-offs

The rationale for typical REIT spin-offs is to provide the market with a more focused, targeted investment opportunity by separating elements of the parent company's property portfolio into a new, independent REIT. Major recent REIT spin-offs have included:

a Simon Property Group's spin-off of its shopping centre business and smaller malls into Washington Prime Group (May 2014);

b Vornado's spin-off of its shopping centre business into Urban Edge (January 2015); and

c Ventas' spin-off of its skilled nursing portfolio into Care Capital Properties (August 2015).

REIT mergers

REIT mergers may be motivated by the advantages of scale, including a potentially lower cost of capital, to benefit from synergies, or to garner other benefits of consolidation. Major recent REIT mergers have included:

a Essex Property Trust's acquisition of BRE Properties, creating a company with a market capitalisation of $15.4 billion (April 2014). BRE shareholders received consideration in the form of Essex stock as well as cash;

b Washington Prime Group's acquisition of Glimcher Realty Trust for $4.3 billion in stock and cash (January 2015). Glimcher shareholders received, for each Glimcher share, Washington Prime common stock and cash; and

5 *Wall Street Journal*, 'Investors Turn to Big Real-Estate Funds' (21 April 2015) (www.wsj.com/articles/investors-turn-to-big-real-estate-funds-1429645516).

6 Preqin Quarterly Real Estate Update, Q1 2016 (https://www.preqin.com/docs/quarterly/re/Preqin-Quarterly-Real-Estate-Update-Q1-2016.pdf).

7 *Bloomberg*, 'U.S. Real Estate to Draw More Foreigners in 2016, Survey Says' (4 January 2016) (www.bloomberg.com/news/articles/2016-01-04/u-s-real-estate-to-draw-more-foreigners-in-2016-survey-says).

c the stock-for-stock combination of Chambers Street Properties and Gramercy Property Trust, creating a company with an enterprise value of approximately $5.7 billion (December 2015). Gramercy stockholders received shares of Chambers Street for each share of Gramercy common stock they owned.

Separation of real estate assets

In situations where real estate owned by an operating non-real estate business would have a higher valuation if held in a REIT, or where separation of the real estate has other advantages, a company may consider strategies to unlock this value. REIT spin-offs and other separations are complex, and may or may not make sense depending on a variety of factors. Recent transactions of this kind include the following:

a Penn National Gaming separated its casino assets into a REIT, Gaming and Leisure Properties, which then leased most of these assets back to Penn National. Shares of the REIT were distributed to Penn National shareholders through a tax-free spin-off in November 2013.[8]

b Sears Holdings sold and leased back 235 of its owned retail assets to a newly created REIT, Seritage Growth Properties, and distributed rights to acquire shares of Seritage to Sears' shareholders in July 2015. The transaction allowed Sears to realise $2.7 billion in value for the assets, funded through the rights offering and financing on the assets.

c After Pinnacle Entertainment announced that it was planning a tax-free spin-off of its real estate assets, Gaming and Leisure Properties made an offer for Pinnacle's real estate assets. After adjustments to the offer and further negotiations between the parties, Pinnacle spun off its operating assets into a separate public company and merged with a subsidiary of Gaming and Leisure Properties in April 2016, and shareholders of Pinnacle received shares of both the new, spun-off operating company and Gaming and Leisure Properties.

ii Private equity transactions

Private equity firms have been increasingly active in real estate M&A, driven by large pools of capital seeking deals. In particular, factors such as higher valuations in the private real estate markets than in the public REIT markets, inexpensive and plentiful debt, and highly liquid private markets that facilitate exit opportunities have driven a number of REIT privatisations, including the following transactions:

a Blackstone purchased Excel Trust, which owned shopping centres and other retail assets, for about $2 billion in July 2015. The deal represented a 15 per cent premium for the target's stock, had a $25 million break fee (if the target terminated the transaction to take a superior proposal), and had a reverse break fee (payable by the acquirer in the event the deal was not completed under certain specified circumstances) of $250 million.

b Lone Star Funds acquired Home Properties, an apartment REIT, for $4.4 billion in October 2015. The deal represented a 9 per cent premium for the target's stock, had a $150 million break fee, and had a reverse break fee of $300 million.

8 Note that tax-free spin-offs of this nature are no longer permissible – see Section V, *infra*, for further information.

c Blackstone purchased Strategic Hotels and Resorts, an owner of luxury hotels, for approximately $6 billion in December 2015. The deal represented a 13 per cent premium for the target's stock, had a $100 million break fee, and had a reverse break fee of $400 million.

d Blackstone also acquired BioMed Realty Trust, which focused on office space for pharmaceutical and biotechnology companies, for $8 billion in January 2016. The deal represented a 24 per cent premium for the target's stock, had a $160 million break fee, and had a reverse break fee of $460 million.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs – structure and role in the market

In 1960, the Real Estate Investment Trust Act became law, creating the REIT structure in the United States. The policy objective of this legislation was to provide small investors the same tax-advantaged opportunities to invest in real estate that were available to institutional or high net-worth investors (who could acquire real estate directly or participate in pooled fund investments in real estate). Under the law, a business entity can elect to be taxed as a REIT (and avoid liability for entity-level US federal income tax) but must comply with an extensive array of restrictions to qualify for this tax-advantaged status. For example, in general a REIT must pay dividends to its shareholders of at least 90 per cent of its taxable income, at least 75 per cent of a REIT's total assets must consist of real estate assets, and a REIT must derive at least 75 per cent of its gross income from real estate-related income (such as rent from real property or interest on obligations secured by mortgages on real property).

These tax rules influence the structure and governance of REITs. In addition to the rules described above, the Internal Revenue Code requires that a REIT have no more than 50 per cent of its shares held by five or fewer individuals, commonly known as the '5/50 rule'. To ensure that the 5/50 rule is not violated, REITs customarily include provisions in their organisational documents restricting any shareholder – an individual or otherwise – from holding more than 10 per cent of their shares, with thresholds often set at a slightly lower percentage such as 9.8 per cent. If properly structured, these ownership limits (called 'excess share provisions') can also act as a takeover defence.[9] The consequences of violating an excess share provision can be severe, so it is essential for acquirors of REIT shares to understand and address the ownership limitations in the target REIT's charter, particularly in unsolicited transactions. Excess share provisions typically allow a REIT's board of directors to waive the limitation with respect to specific shareholders if the board is satisfied that such a waiver will not result in the violation of the 5/50 rule (or other relevant REIT qualification rules), allowing negotiated M&A transactions to proceed.

In addition to these tax complexities, the structure of REITs can often differ from that of a typical public company, since many REITs, called 'UPREITs',[10] include partnership entities in their corporate structure. UPREITs, are REITs that hold their assets and conduct business through an operating partnership in which the REIT is the general partner. Holders of units in a REIT's operating partnership generally have the right to exchange their units

9 For further discussion of the anti-takeover implications of excess share provisions, see Section IV.iii, *infra*.

10 Short for 'umbrella partnership real estate investment trusts'.

for REIT shares or cash (at the election of the REIT). REITs generally choose the UPREIT structure because of the tax advantages that such a structure provides, discussed further in Section IV.v, *infra*.

ii Real estate PE firms – footprint and structure

Real estate private equity funds aggregate investor capital to generate returns through the acquisition, ownership, and sale of real property assets or interests in such assets, and are also active in the origination and trading of real estate debt. Private equity fund managers may choose a particular area of geographical focus, property type, or investment strategy. Core funds tend to invest in stable assets, such as office properties with high-credit-quality tenants located in major urban areas. Opportunistic funds use more leverage and take on higher-risk opportunities (such as developing new buildings or repositioning distressed or poorly capitalised assets). Blackstone, a firm with a leading real estate private equity business, describes the strategy of its opportunistic funds simply as 'buy it, fix it, sell it'[11] – indicating how such funds acquire distressed properties or underperforming REITs and then use their asset management personnel to stabilise these assets or companies prior to sale. Value-added funds tend to adopt strategies and have risk profiles that fall between core and opportunistic funds, and may focus on geographies outside of the largest urban areas.[12] Private equity transactions are often driven by arbitrage opportunities between the public and private markets. When REIT valuations are high relative to the private real estate market, private equity funds may focus on aggregating portfolios that are then sold to REITs (or taken public as REITs). When the reverse is true, and REITs are undervalued relative to the private real estate market, private equity funds may work to take REITs private.

Real estate private equity funds are often structured as Delaware limited liability companies or limited partnerships. Investors commit to provide a specified amount of capital to these funds, as (and when) needed to make acquisitions. Typically, fund managers are compensated with management fees (generally a fixed percentage of the fund's assets under management) and performance fees. These performance fees are generally structured in a waterfall format, under which investors must achieve a specified minimum return (a 'hurdle rate'), before the fund managers earn performance fees. Once the hurdle rate is met, the manager generally earns carried interest (a percentage of overall gains) above the threshold. Private equity fee structures are complex, and can involve tiered hurdle rates, discounts for initial investors, scaled-back management fees or clawbacks of excess carried interest in the later stages of a fund's lifecycle.[13]

11 Blackstone, www.blackstone.com/the-firm/asset-management/real-estate.

12 This investment style overview is based on the categories used by the National Council of Real Estate Fiduciaries (NCREIF).

13 See §1.07 of *Private Equity Funds: Business Structure and Operations*, James M Schell, Kristine M Koren and Pamela Lawrence Endreny (Law Journal Press, 2016).

IV TRANSACTIONS

i Legal frameworks and deal structures

REIT M&A transactions are often structured as triangular mergers. In a triangular merger, the acquiring REIT forms a wholly owned subsidiary (a 'merger sub'), and the target REIT merges with this merger sub. Following the merger, the target REIT becomes a wholly owned subsidiary of the acquirer, which generally allows the target's liabilities to remain at the level of the subsidiary. If the merger sub is the surviving entity in the transaction, the structure is known as a 'forward triangular merger'. If the target REIT is the surviving corporation, it is called a 'reverse triangular merger'. Reverse triangular mergers have a lower likelihood of triggering third-party consent rights in contracts of the target REIT, since the target remains in existence following the merger. The decision to choose a forward or reverse triangular merger structure can depend on these contractual concerns as well as tax issues.

While asset purchases can be an alternative mechanism of acquiring a REIT, and are sometimes considered, the direct transfer of legal ownership of real estate is complex and time-consuming, resulting in considerable transaction costs (including transfer taxes) and sometimes requiring lender or other third party consents.

For REITs structured as UPREITs, parties must consider the best way to combine the operating partnerships of the merging REITs. The partnerships can be combined through a direct merger, through triangular merger structures, or can be left as separate subsidiaries of the parent REIT. Typically, the governing agreements of the operating partnership inform the structuring decision, with key factors including the consent rights of the operating partnership unit holders over REIT-level transactions and the redemption and conversion mechanics that will apply to unit holders following a merger.

In the context of evaluating a merger proposal, REIT directors owe fiduciary duties to the firm and its shareholders, consistent with general corporate law principles. REIT directors are subject to two primary fiduciary duties: the duty of care and the duty of loyalty. To satisfy his or her duty of care, a REIT director must make well-informed decisions based on appropriate knowledge and advice, if necessary. To satisfy the duty of loyalty, a REIT director must act in good faith and in the interests of the shareholders and the REIT (as opposed to his or her personal interest).

Courts in Delaware, where many US firms are incorporated, will review directors' compliance with their duties based on standards that vary based on the situation in which directorial decision-making occurs. The 'business judgement rule' is the default standard of judicial review applying to the actions of directors, under which the business decision-making of a director generally does not give rise to personal liability. However, higher judicial standards apply in situations when a company is being sold. In particular, '*Revlon* duties' apply under Delaware law in the context of a corporate change of control. When a company is engaged in a transaction that may result in a sale, '[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company'. While there is no single blueprint a board must follow in a *Revlon* context, in general, *Revlon* duties require that the board work to maximise the sale price of the business. However, in Maryland, where many REITs are incorporated, a director is not subject to greater scrutiny in a change-of-control context, a significant divergence from Delaware law.[14]

14 Md. Code Ann. Corps. & Ass'ns. §2-405.1(f).

Any REIT sale process should be overseen by the company's board, which should provide management with direction as to any process or potential process. In an auction context, careful consideration should be given to including the right mix of potential bidders to maximise value. Strategic bidders often will have different views of value than financial bidders, since they may be able to capitalise on synergies not otherwise available to financial bidders or because an acquisition fulfils a strategic need or, conversely, because of constraints on their ability to utilise cheap leverage.

Whenever a buyer seeks to retain some or all of the target REIT's senior management, it will be essential to ensure that critical decisions – including the method of sale, selection of bidders, deal protections, access to due diligence materials, and negotiation of the price and other deal terms – fully involve unconflicted directors. In situations going beyond a straightforward desire by the buyer to retain current senior management (for instance when a management team or affiliated stockholder or unit holder seeks out a private equity buyer to submit a joint bid to acquire the company, or in other circumstances presenting more complicated or extensive conflicts), the best way to address the conflict may be to establish a special committee. In situations where directors are also operating partnership unit holders, the board should consider any possible differing interests as between unit holders and shareholders. When a special committee is formed, it should be firmly in control of the process, retain the services of independent legal and financial advisers, and have a clearly defined role, the ability to negotiate independently, and the power to say no. The best way to address conflicts will always depend on the circumstances, however, and care should be taken not to reflexively establish formalistic special committees or otherwise implement drastic measures that end up hurting the process by, for example, depriving the board and bidders of critical access to key executives and their base of knowledge and experience or creating the impression of conflict where it does not truly exist.

Once a merger agreement is signed, federal securities laws impose disclosure requirements with regard to the transaction. A proxy statement is used to provide stockholders with information about the merger, and this proxy statement can be combined with a registration statement for securities used as consideration in the transaction (if any). The SEC may review this registration statement and request changes, a process that may influence the timing of closing.

ii Acquisition agreement terms

Consideration

In a REIT merger, target stockholders receive cash, securities or a mixture of both. When stockholders are receiving stock, the value of the consideration may fluctuate based on the market value of the acquirer's stock in the time period between signing and closing, depending on the specifics of the exchange mechanism. Parties can use a number of techniques to address this risk, including pricing structures based on the average price of the acquirer's stock over a period of time or termination rights triggered by a decline in the acquirer's stock price.

Representations and warranties

The representations and warranties in REIT merger agreements generally resemble those of other public company merger agreements (and do not include the very detailed property-level representations that are common in real estate asset purchases). Instead, an acquirer will often rely on broad representations and a REIT's financial statements and public filings (and will typically get representations relating to their accuracy). The representations and warranties in a REIT merger agreement will serve as a guide for due diligence, as a risk-allocation mechanism, and as a set of preconditions for closing. Representations relating to the tax status of the REIT are particularly important to ensure that the REIT complies with applicable tax regulations (both before and after the transaction).

Covenants

Covenants govern the actions of both the target and acquirer in the period between the signing of the merger agreement and the closing of the merger. In general, these covenants restrict the actions of the target (to prevent significant changes in the business being acquired) and commit the parties to take the steps necessary to close the transaction.

A target will generally agree to conduct its business 'in the ordinary course' consistent with its past practices. However, since this standard can be vague, a merger agreement typically contains a number of specific restrictions, which can include prohibitions on acquisitions, dispositions, material capital investments, or major changes in compensation policies (among other restrictions), unless the acquiring party consents. The target will also typically agree to avoid actions that will compromise its REIT tax status.

In addition to these restrictions on the target, both parties will agree to covenants that bind them to take certain actions necessary to close the transaction. For example, the parties may agree to coordinate on securities filings associated with the transaction, work to acquire third-party consents, and apply for regulatory approvals that may be necessary. Unlike many public-company mergers, antitrust approval is generally not required for US REIT transactions.

Deal protection, termination and break fees

Merger agreements typically also contain provisions governing stockholder approval, fiduciary duty outs and deal protections. A merger agreement would typically require a target's board of directors to conduct a stockholder vote on the transaction, and may also require the board of directors to recommend the transaction to stockholders. In addition, there may be covenants preventing the target from soliciting or facilitating competing bids from other parties (called 'no shop' provisions). However, when covenants such as these are included, a 'fiduciary out' is common, which allows the target's board of directors to change its recommendation or engage with competing bidders should such actions be required by the board's fiduciary duties. Given the importance of these provisions, they are often heavily negotiated.

A merger agreement will contain provisions indicating when either party can walk away from the deal. These provisions may be triggered by an uncurable breach of the merger agreement, failure to obtain shareholder approval, or the failure to close the deal by a specified date. Should an agreement be terminated under certain circumstances (such as pursuant to a fiduciary out in order to accept a superior proposal), the target may have to pay a break-up fee or expense reimbursement fee to the acquirer. Reverse break-up fees (payable by the buyer in the event of certain termination events) are common in private equity deals, and operate much like a traditional real estate deposit. Recent reverse break fees have been asymmetrical, generally exceeding the termination fees payable by the target.

Closing conditions

In general, closing conditions provide a list of events that must occur (or be waived) before the transaction is consummated. For example, closing conditions may include stockholder approval (or approval of unit holders, if necessary), or receipt of necessary consents. In addition, one condition may involve a 'bring-down' of certain representations and warranties, which requires that the representations and warranties made at signing are also true at closing. Other closing conditions may involve the absence of a material adverse change in the target.

Indemnification

Indemnification provisions address the rights of each party to recover damages from the other party in the event of a breach of the merger agreement. Generally, such provisions are not available when the target will cease to exist as a separate, independent entity following the transaction (such as in a merger involving the target). However, they are common when the seller continues to operate after the closing (such as in the context of an asset sale). A party may agree to indemnify the other party for breaches of the representations, warranties and covenants in the merger agreement that survive post-closing. These indemnification obligations may be subject to caps (limiting the indemnifying party's liability) or thresholds (under which indemnification obligations are not triggered unless a liability reaches a certain size).

iii Hostile transactions

Although REITs have a number of defences at their disposal, REITs are still vulnerable to unsolicited offers. The excess share provisions of most REITs can and generally do serve as a form of takeover defence, and many REITs specifically disclose that such provisions may be used for anti-takeover purposes. However, excess share provisions are relatively untested as anti-takeover defences and may be vulnerable because of their grounding in the tax code, or the specific manner in which they are drafted. Excess share provisions – even when designed for anti-takeover purposes – are unlikely to be more powerful or robust than other common takeover defences such as a rights plan, and may often be less so. While hostile takeovers are not common in a REIT context, they have occurred. For example, in 2006, Public Storage successfully completed a hostile takeover of Shurgard, and interlopers making unsolicited bids designed to top announced mergers are rather common.

More recently, activist investors have successfully instigated changes of control at REITs, including, for example, the campaign against the CommonWealth REIT (now Equity Commonwealth) in 2014. Activists may also pressure REIT boards to consider a sale of the company, particularly if there is a large spread between the market value of the REIT and the net value of its assets.

iv Financing considerations

In structuring a transaction (and considering the optimal financing strategy), REIT acquirers must consider both the implications of a transaction on the debt of the target as well as the effects on the acquirer's debt. A transaction may violate change-of-control provisions or covenants in existing debt, or these covenants may create operating difficulties (such as restrictions on asset transfers after closing). Prepayment costs or other fees triggered by the transaction may be substantial, and a careful review of debt documents should occur in conjunction with a planned transaction.

For REITs, after closing, financing can occur at the entity level (in the form of preferred stock or senior or subordinated notes) or at the property level (generally mortgage loans secured by a REIT's assets, which may include issuance of commercial mortgage backed securities). The conditions of any financing commitments for a REIT acquisition should be carefully scrutinised by both the buyer and seller, to eliminate any discrepancies between the closing conditions in the merger agreement and the financing commitments.

v Tax considerations

Given the complexity of tax rules that govern REITs, the tax implications of a transaction are among the most important structuring considerations in a REIT M&A deal. In particular, parties must ensure that the transaction does not create any REIT qualification issues. Depending on the structure of a transaction, the consideration involved in the deal may be wholly or partially taxable to the target REIT or its shareholders, or it may be tax-free (assuming appropriate regulatory and judicial requirements are satisfied). However, transaction structure may also affect the tax basis of the target REIT's assets (specifically, whether the tax basis in such assets is 'stepped-up' following the transaction).

For transactions involving UPREITs, parties must also consider the tax consequences on operating partnership unit holders (especially since the interests of unit holders and shareholders can be different). The UPREIT structure allows REITs to provide property owners the ability to transfer properties to the REIT in a tax-deferred manner, a significant advantage for UPREITs. When property owners transfer a property to the UPREIT and receive partnership units in exchange, owners can defer taxation relating to gains realised on the contribution of this appreciated real estate. As a result, operating partnership unit holders often have tax protection agreements in place (designed to perpetuate a contributing operating partnership unit holder's tax deferral by requiring tax gross-ups if the contributed property is sold or if certain other actions are taken that would accelerate gain recognition to the contributing operating partnership unit holder). This may influence transaction structure at the level of the operating partnership, and can frustrate plans to sell some or all of the assets of an acquired portfolio.

vi Cross-border complications and solutions

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) can create challenges for international investors considering an investment in US real estate. In general, FIRPTA can subject foreign owners of US real property (or interests in certain entities holding US real property) to taxation on gain recognised on the disposition of such property or interests. While dispositions of interests in a REIT can implicate FIRPTA, certain important exceptions may apply. For example, should a REIT be domestically controlled (that is, with under 50 per cent of the value of its shares held directly or indirectly by non-US holders), FIRPTA does not apply to the disposition of shares of such REIT by non-US holders. A similar exception applies to dispositions of stock of a publicly traded REIT by a non-US holder, as long as such holder has not owned more than a specified percentage of the stock during a certain time period.

Acquisition of high-profile real estate assets may be politically controversial, particularly in situations where the acquirer is sponsored by a foreign government entity (such as a sovereign wealth fund). Appropriate communications strategies and partnerships with local players should be considered as strategies to address political implications. Consequently, international investors in the United States often enter into joint venture agreements with local companies to facilitate their entry into the marketplace. While the structuring of these joint ventures can be complex, they have the advantages of allowing foreign investors to leverage the expertise of local companies that are familiar with the local markets.

From a regulatory standpoint, the Committee on Foreign Investment in the United States (CFIUS) can review acquisitions in the United States by non-US acquirers (including real estate acquisitions), but it is unlikely that CFIUS review will affect typical real estate transactions. In addition, a transaction involving a foreign acquirer may implicate US securities laws (if, for example, a foreign company is issuing shares as consideration in a transaction), and the disclosure requirements of these laws and any ongoing compliance costs they may impose should be considered.

V CORPORATE REAL ESTATE

In situations where corporate-owned real estate would have a higher market value if transferred outside of the company (whether to a REIT or a private owner) or where a company's real estate is underutilised or represents 'trapped' value, companies may consider a variety of transactions to unlock the value of their real estate. Such transactions are complex and time-consuming, and may or may not make sense depending on the circumstances. They often have operational implications (particularly where the company no longer has direct control of its real estate), and it is often the case that simpler transactions, like borrowing against the real estate, might better achieve the corporate purpose. Common strategies include sale-leasebacks, joint ventures, or borrowing against the value of the assets with mortgage financing.

Recent tax law changes have complicated these transactions. In the past, corporations with valuable real estate could transfer the assets to a newly formed REIT, spin off the REIT on a tax-free basis to the corporation's stockholders, and enter into a lease agreement with the REIT. However, tax-free REIT spin-offs by US corporations have been prohibited by recent legislation (although such spin-offs by REITs are still permissible). While this change removes one tool used to unlock real estate value, other techniques are still available – for example, taxable spin-offs are still permitted.

VI OUTLOOK

Continued M&A activity is expected among public REITs, both in terms of acquisitions by larger, stronger sector leaders and spin-offs by REITs of their non-core assets. An increasingly vocal group of REIT activists is likely to continue to push for M&A activity, particularly in the case of REITs that trade at a discount to their net asset value. High levels of available private capital, along with easy access to financing, is also likely to continue to spur additional public-to-private transactions driven by private equity buyers. The trend of unlocking corporate real estate value through transactions using the REIT structure will likely continue, although such activity is expected to slow because of the recent restrictions on the use of tax-free REIT spin-offs.

In the short term, adjustments to US tax law, potentially increasing interest rates, or a downturn in the broader commercial real estate market may complicate the outlook for real estate M&A; but in the long term, the liquidity, transparency, and access to capital in the public US real estate market makes the growth of REITs seem inevitable.

Chapter 21

VENEZUELA

Fulvio Italiani, Carlos Omaña, Arnoldo Troconis and Inés Parra[1]

I OVERVIEW OF THE MARKET

The Venezuelan market is less active than other markets in Latin America, mainly because of political and economic instability, high inflation rates, strict foreign exchange control and the consequent reduction of foreign investment.

Real estate ownership and transactions are very common, as they are often used as a way to counter the effects of the high inflation rates and foreign exchange controls. However, these transactions still mainly follow traditional models compared with the real estate M&A and real estate private equity transactions seen in other countries in the region.

II RECENT MARKET ACTIVITY

i M&A transactions

There have been very few real estate M&A transactions as a result of existing current local economic conditions. Because of the foreign exchange restrictions, the real estate market is marked by domestic deals and significant sophisticated international operators focusing on real estate investments in Venezuela are currently rare. The level of real estate transactions in recent years for domestic deals was moderate and mainly fuelled by purchases or sale by local subsidiaries of multinationals in Venezuelan (or certain Latin American investors with high risk appetite). This trend will likely continue during the next few years if the foreign exchange controls are not lifted. The main transactions taking place in Venezuela are related to the purchase, sale, construction, financing, development and acquisition of office buildings, sport training centres, retail stores, hotels and shopping centres projects.

1 Fulvio Italiani, Carlos Omaña, Arnoldo Troconis and Inés Parra are partners at D'Empaire Reyna Abogados.

ii Private equity transactions

There has been no significant real estate private equity activity in Venezuela in recent years.

III TRANSACTIONS

i Legal frameworks and deal structures

In general, M&A transactions in Venezuela are conducted in a fashion similar to those in other jurisdictions:

a the signing of confidentiality agreements or non-binding letters of intent;
b due diligence investigations;
c negotiation of stock or asset purchase agreement;
d signing of the agreement;
e disclosure of the transaction;
f tender offer process (in case of publicly listed companies); and
g closing of the transaction.

The purchase agreement generally contains representation and warranties, indemnification and closing conditions customary for M&A transactions in other jurisdictions. The conditions for closing are frequently the subject of lengthy negotiations between seller and purchaser given the rapidly changing regulatory environment. One particular difference from other countries is that in Venezuela the purchase agreement is generally signed between the purchaser and the shareholder or shareholders of the target company, instead of the target company itself. On the other hand, there is no procedure in Venezuela that allows the squeeze-out of shareholders of a Venezuelan company. These general rules would also apply to real estate M&A transactions.

ii Hostile transactions

There has been no significant hostile takeover activity in Venezuela in general or with regard to public real estate companies since there are actually very few publicly listed companies in Venezuela. Several of these companies have, however, implemented (or, from time to time, continue to implement) traditional defences against hostile takeovers in line with existing international standards, such as repurchases, poison pills and supermajority provisions, among other measures.

iii Financing considerations

There is very limited financing available for deals as a result of existing current local economic conditions.

iv Tax considerations

The sellers of real estate located in Venezuela are subject to income tax at a 34 per cent rate on the gain realised on the sale of the real estate. The sellers must pay an income tax advance of 0.5 per cent of the sale price when signing the sale agreement. The sellers may credit the 0.5 per cent income tax advance against their final income tax liability at the end of the tax year. The purchaser generally pays the registration expenses when registering the agreement.

If the sale of the real estate is made through the transfer of the shares of the company owning the real estate, the purchaser is generally required to practice a 5 per cent income tax withholding on the purchase price if the seller is a domestic or a foreign company. The seller may credit the 5 per cent income tax withholding against its final income tax liability, which is generally of 34 per cent on the gain realised on the sale of the shares. The income tax withholding may be reduced or eliminated if the seller qualifies as a tax resident of a country with a double taxation agreement with Venezuela, and the Venezuelan tax treatment of the capital gain may also vary.

v Cross-border complications and solutions

There are no special tax rules governing the disposition or acquisition of real estate located in Venezuela by foreign investors. Therefore, foreign investors in real estate sometimes structure the sale of real estate located in Venezuela through the sale of the shares of a target company owning the real estate. In such cases, the Venezuelan income tax treatment of any capital gain realised on the sale of the shares of the target company may vary if the seller is a tax resident of a country with a double taxation agreement with Venezuela. Some of the double taxation agreements entered into by Venezuela assign the right to the source state to tax the capital gains realised on the transfer of shares deriving more than 50 per cent of their value directly or indirectly from immoveable property situated in the source state.

Foreign acquirers typically purchase real estate through a Venezuelan company owned by a foreign company to obtain a more favorable tax treatment if the real estate is intended to be leased. This is because lease payments made to Venezuelan companies are subject to a 5 per cent income tax withholding, whereas lease payments made to foreign companies may be of up to 34 per cent.

IV OUTLOOK

Venezuela may well become, in the next couple of years, a country with significant business opportunities for investors with an appetite for risk. In addition to the competitiveness resulting from the recent devaluation, several factors contribute to Venezuela's investment potential:

a Venezuela is one of the largest Latin American economies and one of the world's largest oil producers and exporters, with the fifth-largest proven oil reserves in the world (the largest in the western hemisphere) and, if the estimated 235 billion barrels of extra-heavy crude oil in the Orinoco Belt region are included, the largest hydrocarbons reserves in the world.

b Venezuela has signed economic cooperation treaties with several countries, including Brazil, China and Russia, providing an adequate framework for investments by companies from such countries.

c Venezuela is a party to bilateral investment treaties with several European, Latin American and Asian countries, which provide for adequate compensation in the case of expropriation or nationalisation and access to international arbitration in a neutral forum. These treaties provide protection despite the decision of Venezuela to cease being a member of the ICSID Convention (effective July 2012), as most of these treaties provide for international arbitration mechanisms additional to the ICSID facilities (for example, UNCITRAL).

d Venezuela is also a party to international treaties to avoid double taxation with several countries that protect investors against certain changes in tax legislation.

Appendix 1

ABOUT THE AUTHORS

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Alessandro Balp is a partner in the Milan office and coordinates the firm's real estate practice.

Mr Balp is routinely involved in many of the largest and most complex transactions in the Italian market. His clients in the real estate sector include major property companies, Italian and foreign real estate institutional investors, real estate funds, asset management companies and insurance companies.

He joined BonelliErede in 2001 and became a partner in 2005. From 1999 to 2000, he worked as an associate for Simpson Thacher & Bartlett LLP in New York. Mr Balp graduated with honours from the University of Milan in 1994 and obtained his LLM degree at the Yale Law School in 1999. He was admitted to the Italian Bar in 1998 and is also admitted to the New York Bar.

ROBERT BILECKIJ

Herbert Smith Freehills

Robert Bileckij advises on all aspects of corporate and commercial transactions, mergers and acquisitions, funds management and joint ventures. His focus is on the property funds management industry, combining strong funds and transactional M&A skills with extensive industry experience. He has acted on establishing, investing into and transacting with a broad range of funds clients and structures, through which he has gained a deep knowledge of key drivers and market settings. He advises a number of Australia's largest REITs (both listed and unlisted) on transactions spanning the full real estate funds life cycle.

Mr Bileckij is a member of the Property Council of Australia's Corporate Finance Working Group, which engages on legal and regulatory matters affecting capital markets and the property industry.

SANTIAGO CARREGAL

Marval, O'Farrell & Mairal

Santiago Carregal is a partner in Marval, O' Farrell & Mairal's banking and finance department. He specialises in capital markets and corporate finance and has represented companies and investments banks in more than 180 transactions, including public offerings, private placements and tender and exchange offers, structured and project financings and mortgage securitisation involving a variety of equity, debt and hybrid instruments.

He worked as a foreign attorney for Shearman & Sterling in New York, is a former vice president and assistant general counsel of JPMorgan's Buenos Aires branch, and was a partner of law firm Carregal & Funes de Rioja. Mr Carregal graduated as a lawyer at the University of Buenos Aires in 1984 and went on to earn a master of laws degree from the University of Illinois in 1987.

He is currently a member of the board of the Argentine Bank's Lawyers Committee and a professor of postgraduate studies in banking and finance at the University of Buenos Aires, Austral University and the Pontifical Catholic University of Argentina.

REEBA CHACKO

Cyril Amarchand Mangaldas

Reeba Chacko is a partner in the Bangalore office and a part of the firm's general corporate practice. She also heads the firm's national general corporate practice. She has over 17 years of experience and has been recognised for her expertise in the private equity and venture capital investments, mergers and acquisitions, takeover and joint ventures.

She has been recognised as a recommended PE lawyer by *Chambers Asia* 2012, 2013 and 2014 for as well as for private equity. *Chambers Asia 2015* has named her in the corporate/M&A – India practice for heading up the firm's Bangalore office and is praised for her sound expertise and 'exceptional client management skills'; it has also named her in the private equity – India practice and said she 'is exceptional at client management and making sure that the resources of the firm are involved in the deal'. Ms Chacko has also been named in *Who's Who Legal – The International Who's Who of Business Lawyers – Mergers & Acquisitions 2012* as one of the 13 named lawyers from India.

DIEGO A CHIGHIZOLA

Marval, O'Farrell & Mairal

Diego A Chighizola specialises in banking and finance, real estate development and financing, capital markets, and M&A. He has drafted and negotiated domestic and cross-border agreements for structured financings, syndicated loans, derivatives, acquisitions and joint ventures. He joined Marval, O'Farrell & Mairal in 2001 and became a partner in 2012. He worked in New York as foreign associate at Cleary, Gottlieb, Steen & Hamilton from 2004 to 2005. He graduated in 2001 as a lawyer from the Pontifical Catholic University of Argentina in 2001, obtained a master of laws degree from Columbia University School of Law, New York, in 2004 and a master's degree in finance from the University of CEMA in 2007. He is admitted to the New York State Bar and is a member of the City of Buenos Aires Bar. He currently teaches business law at the University of San Andrés, the University of CEMA and Austral University.

FLÁVIO COELHO DE ALMEIDA

Pinheiro Neto Advogados

Flávio Coelho de Almeida has an LLB (2003) and a postgraduate degree in consumer relations (2006) from the São Paulo Catholic University School of Law, and a postgraduate degree in corporate real estate law from SECOVI University in São Paulo (2010). He is a corporate senior associate that has been working at Pinheiro Neto Advogados' São Paulo office for 16 years. He has a diverse practice in corporate real estate, advising clients on all aspects of real estate law, real estate structuring, construction law and agricultural law.

FREDERIK CORPELEIJN

De Brauw Blackstone Westbroek NV

Frederik Corpeleijn joined De Brauw in 2013 and is an associate in De Brauw's corporate and M&A team, where he has a focus on real estate transactions. He is also a guest lecturer at the University of Amsterdam.

MONA DOSHI

Anjawalla & Khanna

Mona Doshi is a partner at Anjawalla & Khanna and co-heads the firm's real estate practice. She is based in firm's Mombasa office. She also leads the firm's private client law department and is an advocate of the High Court of Kenya.

Ms Doshi is regularly invited to speak at international and local conferences on topics including real estate, estate planning and wealth management for high net-worth individuals in Kenya, and Islamic finance.

She was recommended by the *Legal 500* in the real estate and construction, and banking and finance sectors. She was also praised for being 'extremely professional and diligent in her work'. Ms Doshi was singled out for individual praise and described as 'honestly one of the main reasons for using Anjarwalla & Khanna and will be an authority in times to come' (*IFLR1000 2016*).

ADAM EMMERICH

Wachtell, Lipton, Rosen & Katz

Adam Emmerich practises in Wachtell Lipton's corporate department, focusing primarily on mergers and acquisitions, particularly in the REIT and publicly traded real estate areas, as well as on corporate governance and securities law matters. His practice has included a broad and varied representation of public and private corporations and other entities in a variety of industries throughout the United States and globally, in connection with mergers and acquisitions, divestitures, spin-offs, joint ventures and financing transactions. He also has extensive experience in takeover defence. Mr Emmerich is recognised as one of the 500 leading lawyers in America by *Lawdragon*, as one of the world's leading M&A lawyers in *Chambers*, as an expert in each of M&A, corporate governance and M&A in the real estate field by *Who's Who Legal*, and as an expert both in M&A and in corporate governance by Euromoney Institutional Investor's *Expert Guides*.

STEFAN FEUERRIEGEL

White & Case LLP

A real estate partner based in the firm's Hamburg office, Stefan Feuerriegel provides advice on all aspects of the real estate industry, with particular emphasis on the representation of real estate funds, real estate mergers and acquisitions, and real estate development.

Clients praise his particular experience of handling complex transactions and real estate restructurings, as well as his in-depth knowledge of the shopping centre and hotel and hospitality sectors.

The *Legal 500* lists Dr Feuerriegel as 'highly recommended' and *Chambers* ranks him for real estate funds, project development and M&A deals. He is named in *JUVE* as a frequently recommended real estate lawyer in Germany and *Best Lawyers* voted him one of Germany's best real estate lawyers.

In the past three years, Dr Feuerriegel has successfully advised on some of the most significant recent real estate transactions, such as the acquisition of Tank & Rast (worth more than €3 billion), the planned takeover of supermarket chain Tengelmann by market leader Edeka, and the acquisition of more than 10 shopping centres and 30 hotels. He also offers clients the benefit of his significant experience advising public authorities on the formation and negotiation of public-private partnerships (PPPs).

AILISH FINNERTY

Arthur Cox

Ailish Finnerty is a Dublin-based tax lawyer specialising in corporate tax with a particular focus on tax planning for international clients doing business in and through Ireland. She acts for a broad range of international clients including multinational corporations, private equity houses, hedge funds and financial institutions. Ms Finnerty advises on the tax aspects of a wide variety of transactions, including leasing transactions, mergers and acquisitions, disposals, reorganisations and corporate restructurings, inward investment projects, securitisations and all forms of structured financing.

SOPHIE FREDERIX

Arthur Cox

Sophie Frederix is a Dublin-based M&A lawyer in the firm's corporate group, advising on a wide range of corporate and commercial matters. She has advised a broad range of private companies on high-profile transactions including mergers and acquisitions, corporate reorganisations and restructurings, private equity transactions, limited partnerships and commercial contracts for both Irish and international clients.

LODEWIJK HIJMANS VAN DEN BERGH

De Brauw Blackstone Westbroek NV

Lodewijk Hijmans van den Bergh's practice focuses on corporate law, including governance, advisory and M&A. He joined De Brauw in 1988, and was a partner from 1994 to 2009. From 2009 to 2015, he was chief corporate governance counsel and member of the management board and the executive committee of Royal Ahold. He rejoined De Brauw in January 2016. Mr Hijmans van den Bergh has extensive experience across the field of corporate law. He has also handled a variety of corporate finance matters with a focus on cross-border equity capital market transactions.

FULVIO ITALIANI

D'Empaire Reyna Abogados

Fulvio Italiani is considered one of the leading M&A and corporate lawyers in Venezuela. He has participated in most of the significant acquisition, financing and oil and gas transactions taking place in Venezuela in recent years. Mr Italiani has been consistently ranked as a star individual for M&A/Corporate by *Chambers Latin America*. He was honoured with an award for 'Outstanding Contribution to the Legal Profession' at the 2013 *Chambers Latin America* Awards for Excellence. According to *Chambers and Partners*, He was selected for the prestigious award in recognition of 'his business skills and legal expertise which have been of great benefit to national and multinational companies investing in the challenging economic climate of Venezuela'. *Chambers and Partners* also stated that Mr Italiani 'handles some of the largest financing and M&A deals in the country' and 'is particularly celebrated for his dedication to his clients and his ability to find creative solutions to the most challenging problems'. He has also been named one of 'Latin America's Top 50 Legal Stars' by *Latin Business Chronicle*.

MASAKAZU IWAKURA

Nishimura & Asahi

Masakazu Iwakura is a senior partner at Nishimura & Asahi. He is qualified to practise in Japan and the state of New York.

His areas of practice include mergers and acquisitions, tax, insurance, intellectual property, and litigations. He handled, *inter alia*, JAPAN POST's acquisition of Toll Holdings, Idemitsu Kosan's acquisition of Showa Shell Sekiyu shares from Royal Dutch Shell, the integration of UFJ Bank Group and Mitsubishi Tokyo Financial Group (MUFG), Prudential Financial's acquisition of AIG Edison Life and AIG Star Life, the demutualization and GPO of the Dai-ichi Mutual Life Insurance Company, the integration of Mitsubishi UFJ Securities (and MUFG) and Morgan Stanley Japan Securities and the lawsuit regarding the banking tax against the Tokyo and Osaka Metropolitan governments.

Mr Iwakura has lectured on corporate law, mergers and acquisitions law, intellectual property law, and tax law at various law schools and universities for more than 20 years. He was a visiting professor of law at Harvard Law School in 2007 and 2013 and a lecturer at Kyoto University Law School from 2005 to 2007; furthermore, he has been a professor of law at Hitotsubashi University, Graduate School of International Corporate Strategy since 2006.

HANS-PETER JØRGENSEN

Gorrissen Federspiel

Hans-Peter Jørgensen is a partner in the firm's real estate group and co-head of the firm's real estate M&A group. He has over 25 years of experience with commercial real estate transactions and he has assisted clients in several of the largest and most high-profile transactions in Denmark in the recent years, including those on Illum, Magasin, Galleri K and the PFA portfolio. He advises domestic and foreign real estate clients including real estate private equity funds.

CAROLINE KARUGU

Anjarwalla & Khanna

Caroline Karugu is a senior associate in the real estate and finance department at Anjarwalla & Khanna and focuses mainly on property law, property development work, real estate financing, property joint ventures and structuring of mixed use developments.

She has handled a variety of property transactions, including structuring of property joint ventures, property acquisitions, residential and mixed use projects, large scale commercial retail leasing, property management contracts and securities.

ANNE KIUNUHE

Anjarwalla & Khanna

Anne Kiunuhe is a partner in the corporate department at Anjarwalla & Khanna, Kenya's largest corporate law firm, and an advocate of the High Court of Kenya. With over 10 years of experience as a corporate lawyer, she specialises in mergers and acquisitions, IT and telecommunications law, competition law and intellectual property law.

Having handled a number of prominent corporate law transactions in Kenya, Ms Kiunuhe has represented multinational corporations such as Helios Investment Partners, Essar, Bharti Airtel, Schneider Electric Industries, Centum and Two Rivers Development Limited and is a recognised leader in her field. A pioneer in A&K's growing competition law practice, she spearheaded the first joint Kenya COMESA Competition Conference, which drew leaders from the recently formed COMESA Competition Commission (CCC), the Competition Authority of Kenya (CAK) and international experts. She also represented Kenyan stakeholders at the COMESA Competition Workshop 2014.

Ms Kiunuhe is ranked by the *Chambers Global Legal Directory*, which has described her as a 'very positive and sparky' lawyer and receiving client praise for her drafting skills and contracts analysis. In addition, she was voted one of Kenya's best M&A lawyers by *Best Lawyers International* and won the CfC Stanbic Rising Star Award 2015 in the professional services category.

MATTHEW MACDONALD

Wachtell, Lipton, Rosen & Katz

Matthew MacDonald is an associate in the corporate department of Wachtell Lipton. He received a JD *summa cum laude* from the University of Pennsylvania Law School, where he was a member of the Order of the Coif, senior editor of the *University of Pennsylvania Law Review*, and was awarded the Barenkopf Scholarship (given to the student with the best academic record after the first two years of the JD programme). He also received an MBA from the Wharton School at the University of Pennsylvania, where he was awarded Director's List honours. Previously, he completed his bachelor's degree *cum laude* at Princeton University. Before joining the firm, Mr MacDonald worked at Fidelity Investments, as a member of its internal strategy consulting team, and at Bain Capital, as part of its venture capital and growth equity fund.

ÁNGEL MAESTRO

Uría Menéndez

Ángel Maestro is an associate in the Madrid office of Uría Menéndez. He joined the firm in February 2014, having previously worked at Eversheds (Madrid office). Mr Maestro has extensive experience in corporate and commercial law and focuses on a wide array of commercial real estate transactions.

OENE MARSEILLE

Ali Budiardjo, Nugroho, Reksodiputro

Oene J Marseille graduated from the Faculty of Law, University of Amsterdam, the Netherlands, in 1995 and did a master of laws at Duke University, School of Law, North Carolina. He worked for almost six years with Nauta Dutilh in its offices in Rotterdam and New York and its Jakarta office, and also with White & Case in the Jakarta and Singapore office from August 2001 until April 2005. He is involved in the following practices: corporate, foreign investment, capital markets, corporate and financial restructurings, project finance, energy and resources, aircraft financing, leasing, and mergers and acquisitions.

ANDREY MASHKOVTSEV

Egorov Puginsky Afanasiev & Partners

Andrey Mashkovtsev is a counsel at Egorov Puginsky Afanasiev & Partners. He is a member of corporate and M&A practice of the firm and has a strong track record in advising clients on complex Russian and cross-border M&A, corporate restructurings, and asset deals. His practice focuses particularly on corporate conflicts and special situations.

Mr Mashkovtsev graduated with honours from the law school at Saint Petersburg State University in 2005.

CHRIS MURRAY

Osler, Hoskin & Harcourt LLP

Chris Murray's practice focuses on mergers and investments for REITs, public corporations, private equity sponsors and pension funds. He has been fortunate to have been involved in a wide range of deal sizes and degrees of complexities from *Lexpert* deals of the year to smaller yet still business critical transactions for mid-cap companies.

He also has a wealth of experience in corporate finance having advised on over 100 public offerings and dozens of IPOs in his career, particularly in the REIT sector, where he advises several REITs and has acted on innumerable REIT offerings. He advises a number of public reporting issuers and their boards as well as Canadian pension plans as their principal trusted legal adviser on a range of matters.

Mr Murray leads Osler's Asia-Pacific initiative, having advised a number of Chinese, Korean, Australian and South Eastern Asian based enterprises. He also practised in Australia early in his career while on a two-year secondment from Osler.

YÁSSER-HARBI MUSTAFÁ

Uría Menéndez

Yásser-Harbi Mustafá is a partner in the Madrid office of Uría Menéndez. He joined the firm in 1999 and became a partner in 2010. He advises on all types of real estate transactions and, particularly, on the sale and purchase of companies operating in the real estate sector, asset deals, sale-and-leaseback transactions, loan portfolios and real estate finance.

NAGAVALLI G

Cyril Amarchand Mangaldas

Nagavalli G is a partner in the Bangalore office and a part of the firm's general corporate practice. She specialises in mergers and acquisitions, private equity, real estate financing and joint ventures.

Ms Navagalli has been closely involved in several leading acquisitions, joint ventures, real estate financing, both in public and private companies. Working on cross-jurisdictional matters, she also works closely with international firms. Her work spans advisory (including regulatory), strategic and transaction-related matters. She also services several leading private equity funds as well as several large Indian corporates in connection with investments into companies engaged in business in various sectors in India. Apart from this, she also has significant exposure to labour laws and litigation. She has advised funds like the Blackstone

Group, Samsara Capital, Helion Advisors, Kotak in their investments in India. She has also advised corporate houses like Mantri Developers, Embassy and People Combine in various private equity, merger and acquisition transactions, and advisory matters.

DANIEL NGUMY

Anjarwalla & Khanna

Daniel Ngumy is a partner at Anjarwalla & Khanna and leads the firm's tax department. He specialises in Kenyan and international tax law, and has experience in corporate and commercial legal work.

He is a qualified CPA(K) and holds a bachelor of laws degree from the University of Nairobi as well as a master of laws degree from the University of London (UCL and Queen Mary). Mr Ngumy has over 10 years' experience collectively working for Anjarwalla & Khanna, PricewaterhouseCoopers in Nairobi and KPMG in Europe.

He provides ongoing tax advice on matters affecting clients across various industries, including in the banking, insurance, finance, agricultural, power and infrastructure industries. He also has advised on a variety of matters, from debt and equity capital transactions to mergers and acquisitions.

Mr Ngumy was ranked by *Chambers Global 2016* as a 'notable practitioner' in corporate and commercial.

MICHAŁ NOWACKI

Wardyński & Partners

Michał Nowacki is a legal adviser, tax adviser, and partner in the tax practice. He provides tax advice on Polish and international transaction projects. He advises on transactions involving shares, enterprises, organised parts of enterprises, and real estate. He is involved in reorganisation projects covering mergers, conversions of corporate forms, and spinning off of assets. He provides advice on tax-efficient financing and debt restructuring.

Mr Nowacki provides ongoing tax consulting on issues of corporate income tax, personal income tax, transaction taxes, VAT, and international tax law. He conducts tax reviews, including due diligence projects, and represents clients before the tax authorities and administrative courts.

He is the co-author of *Legal Risks in M&A Transactions*, published by LexisNexis Polska in cooperation with Wardyński & Partners (Warsaw 2013).

Michał Nowacki is a 2005 law graduate of the University of Łódź. He is a member of the Warsaw Regional Chamber of Legal Advisers and the Masovia Chapter of the National Chamber of Tax Advisers. He has worked at Wardyński & Partners since 2008.

EMIR NURMANSYAH

Ali Budiardjo, Nugroho, Reksodiputro

Emir Nurmansyah has worked with ABNR since 1989 and has been a partner since 1 January 1997. He graduated from the Faculty of Law, University of Indonesia in 1989, majoring in Economic Law. In 1993, he earned an LLM degree from the Faculty of Law at Bond University in Australia, majoring in international transactions. He has, since 1993, dealt with a large number of transactions involving privatisation, corporate restructuring, and project and debt financing. He has been involved in most of the restructuring projects in which ABNR is involved; both as a member, and as the leader, of the ABNR team. He has also acted as the adviser of IBRA in several restructuring and asset-disposal projects.

CARLOS OMAÑA

D'Empaire Reyna Abogados

Carlos Omaña is a partner in D'Empaire Reyna Abogados. He is a general practitioner with emphasis on Venezuelan sovereign and quasi-sovereigns international financings, corporate law and gas projects. He has participated in many of the most significant financing transactions taking place in Venezuela in recent years.

ROBIN PANOVKA

Wachtell, Lipton, Rosen & Katz

Robin Panovka co-heads Wachtell Lipton's real estate and REIT M&A groups. He focuses on M&A and strategic transactions across the real estate, REIT, hospitality, gaming and private equity sectors, and also advises on general cross-border M&A and large-scale projects including the redevelopment of the World Trade Center in Manhattan. Mr Panovka has been named one of the *Lawdragon* 500 Leading Lawyers in the United States, and is consistently ranked as one of the leading REIT and real estate M&A lawyers by *Chambers*, *The Legal 500*, *Who's Who Legal* and similar publications. He was recently described in *Chambers* as 'the dean of US REIT M&A'. He is the co-author of 'REITs: Mergers and Acquisitions', a leading treatise published by Law Journal Press, co-chair of the NYU REIT Center, and has served as an adjunct professor at Columbia Business School.

INÉS PARRA

D'Empaire Reyna Abogados

Inés Parra has been partner at D'Empaire Reyna Abogados since 1996. She specialises in corporate law; mergers and acquisitions, capital markets, exchange controls and real estate; she is considered one of the leading M&A and corporate lawyers in Venezuela.

She has broad experience in exchange controls regulations, mergers and acquisitions and real estate transactions.

Ms Parra has been ranked by *Chambers Latin America* as one of the best corporate/M&A and real etate lawyers in Venezuela. *Chambers and Partners* also mentioned that she 'earns warm praise from clients, who note her expertise in acquisitions with a real estate component and her positive disposition in urgent cases'; 'She was always available to us – 24/7;' and 'She understands our needs so well, she even offers solutions to problems we have not foreseen ourselves.'

MARCIN PIETKIEWICZ

Wardyński & Partners

Marcin Pietkiewicz is a legal adviser and a member of the capital markets and financial institutions practices. He is also a member of the new technologies practice, where he advises on crowdfunding and virtual currencies (such as bitcoin).

He handles issues of securities law and the laws of capital markets and financial institutions, capital markets transactions, corporate governance, particularly in public companies, as well as outsourcing and compliance issues.

He is involved in drafting documentation connected with the issue of shares, bonds and structured products. He advises on fund raising on capital markets, takeovers, and acquisition of significant positions in the shares of public companies, performance of reporting requirements related to capital markets transactions, offering of foreign securities in Poland, and regulatory aspects of the operations of financial institutions (brokerages, banks, investment funds and insurance companies), the offering of financial products, and outsourcing of services. He represents clients in proceedings before the Polish Financial Supervision Authority.

He participates in project finance work (credit agreements, share acquisitions, and specific types of financing), purchasing of receivables and related collateral and securitisation matters.

Mr Pietkiewicz graduated from the Faculty of Law and Administration at the University of Warsaw, where he also completed a course in English and European law at the British Law Centre.

From 2003–2004 he worked at Wasylkowski & Partners, which was associated with an international network of law firms cooperating with Deloitte.

He co-authored *Legal Risks in M&A Transactions*, published by LexisNexis Polska in cooperation with Wardyński & Partners (Warsaw 2013). He is a member of the Warsaw Chamber of Legal Advisers. He joined Wardyński & Partners in 2004.

PHILIP PODZEBENKO

Herbert Smith Freehills

Philip Podzebenko's work encompasses a broad range of corporate, funds and securities law, focusing on inbound Australian acquisitions by investment funds, mergers and acquisitions, and capital markets transactions. He advises leading property funds, infrastructure investors, investment banks, Private equity funds, state-owned enterprises, and other Australian and international businesses.

Mr Podzebenko is a member of the Legal Roundtable for the International Institute for the Study of Cross-Border Investment and M&A sponsored by NYU Stern, Guanghua School of Management and the University of Cambridge.

MARK REBERGEN

De Brauw Blackstone Westbroek NV

Mark Rebergen's expertise bridges corporate, finance and real estate law. He has been involved in many international transactions where his broad experience and multi-disciplinary knowledge is a significant asset. He often also works closely with and coordinates teams of De Brauw's specialists when complex matters demand know-how covering the full spectrum of legal issues. Mr Rebergen returned to the firm's Amsterdam headquarters in August 2014 after having been resident partner at De Brauw New York since 2011. He has advised clients ranging from Dutch and US multinational companies to private equity firms and global banks on corporate structuring, acquisitions and related financing, stand-alone debt and equity financing, contract law and real estate matters. Real estate matters Mr Rebergen has worked on include the sale of Philips' High Tech Campus and matters for Lone Star.

GUSTAAF REERINK

Ali Budiardjo, Nugroho, Reksodiputro

Gustaaf Reerink graduated from Leiden University, where he earned an LLM in private law, an MA in Indonesian studies, and a PhD in law, governance and development. In addition, he studied French at the University of Burgundy in Dijon, and read law at King's College London and the School of Oriental and African Studies in London. Prior to joining ABNR, Mr Reerink worked as an associate in the Amsterdam and Brussels offices of Dutch law firm De Brauw Blackstone Westbroek. His current practice encompasses foreign investment, corporate, mergers & acquisitions, energy and resources, and related regulatory and compliance matters. He regularly publishes articles on Indonesian legal matters and serves as a guest lecturer at the Indonesian Ministry of Law and Human Rights and several Indonesian universities. He is admitted to the Amsterdam Bar.

PAUL ROBINSON

Arthur Cox

Paul Robinson is a Dublin-based M&A lawyer in the firm's corporate group and has extensive experience advising on a wide range of corporate and commercial transactions. He has been involved in a large number of high-profile acquisitions and disposals in the Irish market and regularly advises leading Irish and international public and private companies, as well as private shareholders, on all aspects of corporate and commercial law with a particular emphasis on, mergers and acquisitions, joint ventures, private equity, limited partnerships and cross-border mergers and reorganisations. He has advised numerous international clients on Irish acquisitions and previously worked in the private equity industry.

VANDANA SEKHRI

Cyril Amarchand Mangaldas

Vandana Sekhri is a partner at the firm's Mumbai office. She is currently part of the general corporate practice group and specialises in private equity, joint ventures and corporate commercial transactions. She has previously advised private equity funds, banks, financial institutions, hedge funds in their investments across various companies in India.

CYRIL SHROFF

Cyril Amarchand Mangaldas

With over 34 years of experience in a range of areas, including corporate - M&A and private equity, securities law, disputes, banking, infrastructure, private client, financial regulatory and others, Cyril Shroff is regarded and has been consistently rated as India's leading corporate, capital markets and finance lawyer.

He has been recognised as a 'legendary figure in the Indian legal community' and is consistently ranked as 'star practitioner' in India by *Chambers Global* and other directories. He was awarded the ALB Managing Partner of the Year for 2015.

Mr Shroff is also a member of the Advisory Board of the Centre for Study of the Legal Profession established by the Harvard Law School, a member of the Advisory Board of the National Institute of Securities Markets (NISM) and on the board of the Indian Institute of Management, Trichy. He is a director on several boards and member of various committees. He also regularly comments and advises on policy reforms in India.

JACK SILVERSON

Osler, Hoskin & Harcourt LLP

Jack Silverson specialises in taxation with a focus on the income tax aspects of corporate finance, including developing debt, equity and trust financings, mergers and acquisitions and reorganisations. He has extensive experience with respect to advising tax exempt entities, real estate investment trusts and income funds. During 1991–1992, Mr Silverson was seconded as the special adviser to the director of the Current Amendments and Regulations Division of Revenue Canada and is a former member of the CBA-CICA Joint Committee on Taxation. He is cross-appointed to the pensions and benefits department and was recently appointed as head of the Osler pension investment group.

CHRIS SMITH

Slaughter and May

Chris Smith is an associate in Slaughter and May's corporate department. He has a range of transactional and general corporate advisory experience.

RICHARD SMITH

Slaughter and May

Richard Smith has a broad corporate and corporate finance practice with particular experience in public and private M&A and equity capital markets work. His listed company clients include Land Securities, GlaxoSmithKline, Centrica, Aviva, United Utilities, Close Brothers, Arrow Global, Stock Spirits and Countrywide.

ŁUKASZ SZEGDA

Wardyński & Partners

Łukasz Szegda is a legal adviser and partner who heads the banking and finance practice. He handles financing of transactions, including corporate acquisitions, real estate transactions, development projects, debt restructuring and refinancing. He has taken part in some of the largest debt restructuring projects in Poland and is a permanent adviser to Polish banks. He represents clients in litigation and bankruptcy proceedings. He advises clients on regulatory issues such as cash pooling, outsourcing, securitisation and consumer credit.

Mr Szegda is a graduate of the Faculty of Law and Administration at the University of Warsaw, where he also completed with distinction a course of study in English and European law at the British Law Centre, and a course of study on US law at the American Law Center, a joint initiative of the University of Florida Frederic G Levin College of Law. He holds diplomas in the joint ventures and M&A modules of the IBA International Practice Diploma Programme (developed by the International Bar Association and the College of Law of England and Wales). In 2006, he was seconded to the banking group of the London office of Simmons & Simmons.

He is the author of numerous publications on banking and finance, and co-authored *Legal Risks in M&A Transactions*, published by LexisNexis Polska in cooperation with Wardyński & Partners (Warsaw 2013).

He is a member of the Warsaw Regional Chamber of Legal Advisers and a member of the IBA Banking Law Committee. He joined Wardyński & Partners in 2000.

MACIEJ SZEWCZYK

Wardyński & Partners

Maciej Szewczyk is a legal adviser and a member of the corporate and M&A practice at Wardyński & Partners. He is involved in M&A transactions and ongoing legal assistance to companies. He has taken part in numerous transactions involving acquisition and sale of enterprises and shares.

Maciej Szewczyk graduated from the Faculty of Law and Administration at Adam Mickiewicz University in Poznań (2007).

He is the co-author of *Mergers and Acquisitions Transactions* (Warsaw 2011), *Legal Risks in M&A Transactions* (Warsaw 2013) and *Environmental Law in M&A and Real Estate Transactions* (Warsaw 2014), published by LexisNexis Polska in cooperation with Wardyński & Partners, as well as *Climate Change Liability: Transnational Law and Practice*, published by Cambridge University Press (2011). Mr Szewczyk is a deputy editor-in-chief of the legal portal 'In principle' (www.inprinciple.pl).

He is a member of the Poznań Chamber of Legal Advisers. He joined Wardyński & Partners in 2007.

HENRY SZTUTMAN

Pinheiro Neto Advogados

Henry Sztutman has an LLB from the University of São Paulo Law School (1992) and a bachelor's degree in business administration from the School of Business Administration at the Getúlio Vargas Foundation (1991). He is a corporate partner at Pinheiro Neto Advogados' São Paulo office, having also worked as visiting associate at the New York office of Davis Polk & Wardwell (1997–1998). Mr Sztutman has been working at Pinheiro Neto's São Paulo office for 26 years. He has been the chair of the legal committee at the Brazilian Association of Public Companies (ABRASCA) since 2005. He specialises in mergers and acquisitions, local and cross-border transactions, with a strong practice in representing private equity firms in their investments in Brazil.

ARNOLDO TROCONIS

D'Empaire Reyna Abogados

Arnoldo Troconis has been a partner at D'Empaire Reyna Abogados since 1996. He specialises in corporate law as well as M&A, representing both foreign and national companies.

Mr Troconis has been considered over the years as an experienced top corporate lawyer in Venezuela. *Chambers & Partners* has highly ranked him for several years now, stating in their 2011 review that 'Arnoldo Troconis is highly regarded for his wide-ranging knowledge of corporate law and negotiation skills'.

ALEJANDRO TRUJILLO

Galicia Abogados

Alejandro Trujillo is a partner at Galicia Abogados and head of the real estate practice group since October 2015. In the 10 years prior to Galicia Abogados, Mr Trujillo held various legal positions at GE Capital Real Estate, including general counsel for the company's real estate equity and financing businesses in Mexico. He was previously a senior associate at Martinez, Algaba, De Haro, Curiel & Galvan-Duque SC in both its Mexico City and Monterrey offices, and also a foreign associate at Pillsbury Winthrop Shaw Pittman LLP in New York City. He studied law at Universidad Panamericana and has a Global MBA from the Thunderbird School of Global Management/ITESM.

Mr Trujillo was responsible for the legal operation of a GE $5 billion commercial real estate business in Mexico, where he led legal and cross-functional local and international teams in the structuring, negotiation, and closing of commercial real estate transactions, including lending, restructures, syndications, loan portfolio acquisitions, equity investments, SPV and JV incorporation, asset dispositions and acquisitions, as well as defining the legal strategy for real estate-related litigation.

Among other important transactions that Mr Trujillo structured, negotiated and closed during his tenure at GE, are the startup in 2006 of GE's new equity business in Mexico (Intramerica Real Estate Group), after the acquisition from Finsa of a $460 million industrial portfolio; the $352 million purchase in 2007 by GE of Intermex's industrial assets; the $100 million GE-Vesta joint venture in 2007 to build Bombardier's Aeronautical Industrial Park in Queretaro; a GE $800 million loan restructure and assumption by FibraUNO from the acquisition of commercial buildings owned by Gicsa; GE's asset sale in 2012 of its $830 million industrial portfolio to FIBRA Macquarie, including a $735 acquisition facility granted by GE; the $100 million sale by Eurohypo to GE in 2012 of five commercial real estate loans; and the sale in August 2015 to Blackstone of GE's $3.7 billion commercial real estate loan portfolio in Mexico with a $3 billion seller financing also provided by GE to Blackstone.

HAJIME UENO

Nishimura & Asahi

Hajime Ueno is a partner at Nishimura & Asahi has an integral role in the restructuring and corporate finance practice group, and has been recognised in a number of individual publications, including *Best Lawyers Japan*, *IFLR 1000* and *Asialaw Leading Lawyers*. He predominantly focuses on corporate finance and restructuring transactions – both international and domestic, including structured finance and banking – and regulatory matters.

Among recent transactions, Mr Ueno was involved as a core team member in the corporate reorganisation of Japan Airlines Co Ltd, the integration of Mitsubishi UFJ Securities (and Mitsubishi Tokyo Financial Group) and Morgan Stanley Japan Securities, the capital restructuring and subsequent reorganisation of Tokyo Electric Power Company, Limited, and the privatisation of New Kansai International Airport and Osaka International Airport, while at the same time being involved in REIT transactions and structured finance transactions with novel structure or asset types.

He was previously seconded to a top-tier US international law firm for one year following his graduation from Harvard Law School. Having spent part of his childhood in the United States, he is fluent in English, and has written and spoken on various areas of corporate and banking law in Japan.

MICHAEL WEJP-OLSEN

Gorrissen Federspiel

Michael Wejp-Olsen is a partner in the firm's corporate M&A group and co-head of the firm's real estate M&A group together with Hans-Peter Jørgensen. He focuses principally on general cross-border M&A as well as M&A and strategic transactions across the real estate, hospitality and retail sectors. He represents a variety of real estate private equity funds and other real estate investors active in the Danish market and has been heavily involved in the majority of transactions involving large-scale commercial real estate in central Copenhagen, including the Illum and Magasin properties and the Galleri K property. Mr Wejp-Olsen holds degrees from the University of Copenhagen and the University of Chicago.

MICHAŁ WONS

Wardyński & Partners

Michał Wons is a legal adviser and member of the real estate and construction practice. He has extensive experience advising investment funds and on real estate transactions, particularly, the acquisition of properties, commercialisation of office buildings, and preparation of real estate due diligence reports. He advises on major real estate development projects at every stage of implementation. He also conducts judicial and administrative proceedings, especially property disputes, as well as commercial litigation. He has negotiated numerous contracts related to property development and infrastructure projects and also handled reprivatisation cases with restitution of property in-kind or through compensation. He is a co-founder and leader of the firm's Spanish Desk established to serve Spanish-speaking clients. For several years, he has advised Spanish investors on their real estate activity in Poland. Mr Wons is a law and history graduate of the University of Warsaw (2005) and a member of the Warsaw Chamber of Legal Advisers. He joined Wardyński & Partners in 2006.

SAMMUEL (XIYONG) ZHAO

JunHe LLP

Sammuel Zhao is a partner and a member of managing board of JunHe LLP. He holds an LLB degree and a PhD in economics.

He has over 17 years' experience in legal practice in China and specialises in mergers and acquisitions related to capital markets, RMB fund formation, and mergers and acquisitions and financing of the real estate industry.

Mr Zhao serves as the vice president of the China REITs Alliance. He acted as the PRC legal counsel for BHG Retail REIT's listing on the Singapore Exchange.

IZABELA ZIELIŃSKA-BARŁOŻEK

Wardyński & Partners

Izabela Zielińska-Barłożek is a legal adviser and partner in charge of the firm's M&A practice. She also leads the environmental law practice and heads the Poznań office. She provides legal support for M&A transactions and ongoing advice on corporate law.

In her long practice, she has advised on transactions and coordinated legal support for acquisition and sale of enterprises and assets as well as shares in companies, also in cooperation with foreign law firms on global transactions. She has taken part in many enterprise restructuring projects, including mergers and reorganisations. For many years, she has headed teams of lawyers conducting comprehensive due diligence projects.

She is involved in the activities of international associations, serving as chair of a committee at Lex Mundi (a network of renowned independent law firms throughout the world) and chair of the Servicing Industry Subcommittee at the Real Estate Committee of the International Bar Association, among other posts.

Ms Zielińska-Barłożek graduated in law from Adam Mickiewicz University in Poznań (1996), where she also completed postgraduate studies in European law (2004). She was admitted to the Poznań Chamber of Legal Advisers in 1999.

She is the co-author of *Mergers and Acquisitions Transactions* (Warsaw 2011), *Legal Risks in M&A Transactions* (Warsaw 2013), and *Environmental Law in M&A and Real Estate Transactions* (Warsaw 2014), published by LexisNexis Polska in cooperation with Wardyński & Partners. Ms Zielińska-Barłożek has worked at Wardyński & Partners since 1997.

Appendix 2

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