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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 25 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 approximately US$1.7 trillion globally, including over US$1 trillion in the United States and approximately US$200 billion in each of Europe and Asia. As public REITs and other vehicles have aggregated these properties and grown in scale and sophistication, so too have real estate-focused private equity funds, playing an important role catalysing hundreds of billions of dollars of REIT and real estate M&A transactions and IPOs.

However, despite 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 US$5 trillion and counting, so far – will inevitably seek the advantages of liquidity by migrating to the publicly traded markets. The growth is expected to be both local and cross-border, with approximately 40 countries already boasting REIT regimes.

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

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

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

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

Adam Emmerich and Robin Panovka
Wachtell, Lipton, Rosen & Katz
New York
August 2019
Chapter 1

ARGENTINA

Diego A Chighizola and Agustina Gallo Toppino

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, gyms, swimming pools and tennis courts, among other amenities typical of gated communities. Another popular concept of the same period was the introduction of ‘lofts’. Lofts 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; 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.

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 and 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.

The substantial yearly growth of the construction sector between 2003 and 2008 was 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 in relation to the Argentine peso.

1 Diego A Chighizola is a partner and Agustina Gallo Toppino is an associate at Marval, O’Farrell & Mairal.
Since the administration change at the end of 2015, the current government has made it a top priority to attract foreign direct investment; to this end Argentina has relaxed and almost completely removed previously existing foreign exchange restrictions and passed a new tax amnesty, resulting in the declaration of more than US$116 billion.

The current government has executed several significant economic and policy reforms that have resulted in the temporary revitalisation of the capital markets and an increase of interest from the private sector in the issuance of debt and equities in the domestic and international capital markets. Several programmes of mortgage loans for housing construction have grown in importance, mainly as a result of the ProCreAr programme, the launching of new loans with UVI or UVA (housing units) and new mortgage loans from banks like Ciudad or Nación that reactivated the real estate market temporarily during 2017 and 2018. In spite of these efforts, due to lack of financing options, high inflation rates and devaluation, there has been a significant reduction in construction and real estate activity. In fact, an overview of the real estate market information would show few residential sector transactions in recent years.

It is worth noting that even with the changes in the economy and the fact that culturally, and in the absence of other investment alternatives, Argentine investors have 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. 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.

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 over the past few years.

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, as well as the enactment of a law that restricts ownership and possession of rural land by foreigners. Furthermore, the hotel sector, which originally benefited from the tourism boom in Argentina, has ended up suffering because of an increase in costs as a consequence of inflation and a decrease in the competitiveness that was originally bolstered by foreign exchange rates.

Recent real estate trends show that the construction of big areas for hypermarkets, houses and working spaces has slowed down, and focus has shifted to the worldwide trend of small premises with little square footage and amenities with low or premium (for high-income individuals) expenses.

ii Private equity transactions

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.

In 2018, Equity International, Goldman Sachs and Centaurus Capital, in partnership with Grupo Pegasus, announced the formation and US$300 million investment of ARG Realty Group, a commercial real estate company based in Buenos Aires, Argentina. The
transaction included the acquisition of Pegasus Real Estate Fund’s one thousand square foot class A office and retail real estate portfolio. ARG Realty Group now represents one of the largest real estate platforms in Argentina and is being led by its development company Rukan, which previously developed some of Argentina’s most iconic real estate projects.

III REAL ESTATE COMPANIES AND FIRMS

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

In Argentina there are few 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 four 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 individuals or private funds, 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; and
- d) RAGHSA SA: completely owned by private investors. In 2017, the company issued several notes totalling US$150 million.

Among the most significant development transactions, Consultatio developed Catalinas Norte, which, at 150 metres is the tallest building in the City of Buenos Aires and is 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.

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

IRSA SA is developing the following residencies, retail spaces and offices: Expansión Alto Palermo, Lindero Dor – Ciudad de Buenos Aires and the Catalinas Building, among others.

RAGHSA SA is currently developing offices in a project named Centro Empresarial Libertador.

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 clawback.

(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 can usually request the sale of a specific real estate property at a specific sale price, providing thereby a first-offer pre-emptive right to the other members of the fund. If the parties fail to exercise this right then the general partner or managing partner may proceed to the sale of the specific 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 very widely used tools for pooling funds for development of mostly residential but also commercial projects. In exchange, investors receive an apartment or unit once the project is finished. There are many of these private trusts focused on constructing residential or office buildings; the 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; 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. In contrast, when a real estate project is channelled through

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2 The trustee is usually appointed by the developer.
one or more corporate entities that, in turn, may develop more than one project at a time, the poor performance of one of the projects may negatively affect the others and creditors of one project may legitimately claim from the profits of other projects being developed through the same corporate entity. Additionally, trusts provide not only 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.). This flexibility is not available for projects or developments being channelled through a corporate vehicle.

In reality, given the great flexibility and the risk-isolation benefits provided by the trust structure, many recent real estate developments have been channelled in this way. And although trusts are very popular, there are only a few cases of them being publicly listed. One listed trust had Consultatio acting as developer. Another publicly listed trust has Pilay acting as a developer and is intended to finance the construction of buildings in the metropolitan areas of the cities of Cordoba and Rosario.

During 2016 and 2017, a tax amnesty programme was put in place in Argentina by governmental authorities. One of the programme options allowing participants to avoid paying a penalty fee to the tax authorities was to invest their money in real estate development funds. The investment in these kinds of funds is not to be withdrawn for a period of five years, the minimum amount to invest was US$250,000 and the funds had to include at least three real estate projects. As a result, several funds were created, such as Allaria Residencial CasasARG, Consultatio Inmobiliario, Quinquela + Predial Inmobiliario and Inmobiliario AlRio.

In February 2019, the National Securities Commission (CNV) approved the largest closed mutual fund (FCI) ever placed in the Argentine capital markets, which will be used for the development of real estate projects with a residential purpose under the advice and development of Miyagi S.A. The FCI raised approximately 4 billion pesos (approximately US$88 million) and will be managed by Allaria Fondos.

IV 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, for example, acquisitions comprising the control of a closed company that controls a public company, coupled with acquisitions of direct holdings in the public entity (this structure being 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 (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 currently being studied.

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 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.) 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 when 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 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 Law No. 19,550, the Companies Law (the CL) or any specific law. General rules of the CL apply to takeover bids, but these 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 the 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 rarity of hostile takeovers in Argentina has led local companies to feel no 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, discriminatory rules favouring some shareholders over others are prohibited. However, some listed companies have included specific change-of-control provisions in 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 as regards the types of actions it can take to block a takeover bid, since directors are constrained to act in the company’s interests.

Thus, because of the nature of the capital market and the conditions set by Law No. 19,550, no successful hostile transactions have occurred.

iv Financing considerations

Trusts

The trust model was historically governed by Law No. 24,441, and nowadays is included in the CCC (modified by Law No. 24,770). 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 to avoid insolvency issues by isolating them in an independent estate and 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 two forces that proved to be disruptive in the local financial market: inflation and lack of long-term financing.

Even though there has been a continuous increase of interest rates in the past few months, 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. An example of these features are transactions that include terms that allow lender to request payment of principal and interest in a foreign currency, local currency at a specific exchange rate, or payment in kind.

In the recent past, foreign exchange restrictions used to be an important factor that restricted heavily the ability of receiving financing in Argentina. However, since the current administration took over, these restrictions have been progressively abrogated to the extent that there are no pending foreign exchange restrictions standing.

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.

Despite the measures adopted by the current government to improve the Argentine financial market, which initially resulted in an increase in the issuance of debt and securities and in cross-border loans (e.g., there have been many bond issuances by the national and provincial governments), at present the absence of financial loans is remarkable. Offers of both personal and asset-backed guaranteed loans are limited and there is considerable uncertainty on whether the situation will improve in the short term.

**Tax considerations**

Law No. 27,430 published in the Official Gazette on 29 December 2017 (the Tax Reform) introduces important amendments to the Argentine tax system. Before the Tax Reform, subsection w) of Section 20 of the Income Tax Law provided that the results from operations of sale, transfer or disposition of participations, bonds and other securities obtained
by individuals and undivided estates located in Argentina were exempt from income tax whenever they were listed on stock exchanges or securities markets and had public offer authorisation.

The Tax Reform modifies the aforementioned subsection and establishes that only the results from the sale, transfer or disposal of shares, securities representing shares and certificates of deposit of shares that are carried out through stock exchanges or stock markets authorised by the Argentine Securities and Exchange Commission are exempt. A tax is applicable to net income from Argentine sources belonging to individuals and undivided estates arising from profits related to interest or return on the placement of deposits made in financial institutions, public securities, negotiable obligations, share of mutual funds, debt securities of financial trusts, bonds and other securities, and would be reached at the tax rate of 5 per cent if it is issued in Argentine currency without an adjustment clause or 15 per cent in the case of Argentine currency with an adjustment clause or if it has been issued in foreign currency. The foregoing exemption is also applicable to foreign beneficiaries to the extent that said beneficiaries do not reside in and the funds do not come from non-cooperative jurisdictions. For foreign beneficiaries the exemption is also applicable to public securities issued by the national, provincial, municipal or the City of Buenos Aires governments, negotiable obligations and representative shares or deposit certificates shares and other securities, provided that such securities have been issued by entities domiciled or located in Argentina. Notwithstanding the above, the exemption would not be applicable for letters of the Central Bank (LEBACs).

For the transfer of shares, representative securities, deposit certificates shares and any type of corporate participations that are not placed by public offering, the tax rate is 15 per cent. The sale of real estate or transfers of property rights is included in the tax rate.

In an M&A transaction, when both seller and buyer are not Argentine residents, the seller may choose between an effective tax rate of 13.5 per cent of the sale price and 15 per cent of the ‘real’ net income. Previously, the buyer was responsible for paying the tax when the seller was a non-resident. Currently, in transactions between non-residents, the non-resident seller is responsible for paying the tax through their legal representative in the country. If the seller does not have a legal representative domiciled in the country, the seller can pay the tax via international wire transfer. If the seller is a non-resident and either the purchaser is a resident or the transaction is completed through a stock exchange market or authorised agent, the purchaser or the stock exchange market and authorised agent are responsible for withholding the tax.

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. The tax is usually 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.

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. One of the most important measures in this regard is the lifting of restrictions on the foreign exchange market by the Macri 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
As a consequence of Argentina’s 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.

The measures adopted by the government, focused on generating a more business-friendly climate are still not enough to attract foreign investment to finance economic growth or bring down inflation.

A general election will be held in October to elect the president of Argentina and President Mauricio Macri will probably run for a second term. However, there is still uncertainty about the possible outcome of the election and the subsequent development of the Argentine economy.
Chapter 2

AUSTRALIA

Philip Podzebenko and Robert Bileckij

I OVERVIEW OF THE MARKET

The Australian real estate market is highly securitised, with a significant majority 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 over 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 REIT sector in Australia, with both listed REIT managers and privately owned fund managers also managing unlisted real estate funds targeting Australian and offshore institutional investors and sovereign wealth funds, primarily through syndicate, club and joint venture style structures.

As a result, larger real estate transactions in Australia tend to reflect a ‘securitised’ model involving large-scale mergers and acquisitions, takeovers, spinoffs and other securities market transactions (as distinct from the more traditional real estate conveyancing). The past 12 months has seen continued high levels of activity in the sector, including hostile and friendly takeover activity, reconstructions and divestment of large portfolios. This reflects a continuation of the 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 2018, total foreign investment in the sector was estimated at over A$7.4 billion, involving over 70 transactions.\(^3\)

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1 Philip Podzebenko and Robert Bileckij are partners at Herbert Smith Freehills. The authors would like to thank Melita Cottrell, partner, Herbert Smith Freehills who wrote the banking section, and Daniel Sydes, director, Greenwoods & Herbert Smith Freehills, for the tax section. The authors would also like to thank Timothy Coorey, graduate solicitor, Herbert Smith Freehills and Bianca Doyle, business development adviser, Herbert Smith Freehills for their assistance with background research.


3 Based on S&P Capital IQ data on ‘Foreign Investment in Australian Real Estate’ for the period from 1 January 2018 to 31 December 2018.
International private equity firms, and Australian-based private equity-style real estate managers, have also been active in the Australian market over the past 12 months.

II RECENT MARKET ACTIVITY

i M&A transactions

The past 12 months have been characterised by an increase in high-profile REIT M&A activity in the public markets. Two of the more significant transactions are:

a the acquisition of Investa Office Fund by Oxford Properties; and

b the acquisition of the Propertylink Group by ESR.

Oxford Properties’ acquisition of Investa Office Fund

Investa Office Fund was an externally managed REIT with a portfolio of office properties primarily located in Sydney, Melbourne and Brisbane. It had a market capitalisation of approximately A$2.6 billion.

In May 2018, Investa announced that it had received a non-binding proposal from funds advised by Blackstone to acquire all of the securities in Investa for cash consideration totalling approximately A$3 billion, and that the parties had agreed a process for implementation of the proposal.

Shortly before Investa’s security holders were due to vote on Blackstone’s proposal, in September 2018, Oxford Properties gave Investa an unsolicited conditional proposal to acquire all of its securities at a 15 per cent premium to Blackstone’s offer. Oxford Properties eventually acquired Investa for approximately A$3.4 billion.

ESR’s acquisition of Propertylink Group

Propertylink Group was an internally managed stapled REIT with a portfolio of logistics and warehouse properties primarily located in Sydney, Melbourne and Brisbane. Propertylink also managed wholesale funds focusing on logistics, warehouse and office property.

Warburg Pincus-backed industrial property fund manager, ESR, first acquired a stake in Propertylink in October 2017, buying 19.9 per cent of Propertylink’s securities. In September 2018, it agreed terms with Propertylink to acquire Propertylink’s remaining securities using a takeover offer, valuing Propertylink at over A$700 million.

ii Private equity transactions

International real estate private equity firms, and Australian-based private equity-style real estate managers have been active in acquiring and disposing of a range of real estate assets over the past few years, including, in the past 12 months, through public capital markets and corporate real estate transactions.

Recent transactions include the acquisition of the Propertylink Group by ESR (see Section II.i).
III REAL ESTATE COMPANIES AND FIRMS

1 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 assets and active business operations.

The top 20 ASX-listed REITs range from a market capitalisation of over A$24 billion to a market capitalisation of about A$1 billion. The largest REIT, Goodman Group, is an integrated industrial property manager with assets across Australia, the Americas, Asia and Europe. The next largest REIT, the retail property focused Scentre Group, has a market capitalisation of over A$20 billion.

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 by the trust are taxed in the hands of investors at their applicable tax rates (see further Section IV).

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 REITs 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 treatment for passive real estate assets 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 Commonwealth government has recently reviewed use of stapled structures in the infrastructure and real estate sectors, and has proposed tax law changes limiting their use – see further Section IV.v, below.

The stapled structure has also been used to enable ‘internalisation’ of management of REITs. Internalisation involves the REIT’s management platform 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 REITs have tended to focus on more traditional real estate classes (retail, office, industrial and residential). More recently there has been increasing interest in alternative real estate classes including health care, aged care, retirement living, student accommodation, childcare, manufactured housing and data centres. 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. In 2016, the largest REIT IPO – Viva Energy REIT – was of a specialised service station portfolio. Convenience Retail REIT, which owns a smaller portfolio of service stations, was the only REIT IPO in 2017, raising A$162 million.

The Australian market is also characterised by a number of large listed integrated property companies whose activities cover development and construction as well as asset

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ownership and management through a stapled REIT structure. Groups such as the Lendlease Group and Mirvac have a multi-disciplinary focus across the full spectrum of the property life cycle.

Many of the larger listed REITs and property companies have a significant global footprint. For example, the Goodman Group and Lendlease Group have operations in Australia, the Americas, Europe and Asia.

ii Real estate PE firms – footprint and structure

Real estate private equity managers in Australia comprise a mix of:

a Australia-based specialist real estate managers, including Altis, Centuria Capital and CorVal;

b international private equity and multiple asset class fund managers, including Blackstone Real Estate, Brookfield, ESR, Macquarie Bank, Morgan Stanley Real Estate Investments and KKR, for whom real estate funds are one of the asset classes which they offer investors; and

c ASX-listed REITs and developers, including Charter Hall, Dexus, Goodman Group, Lendlease, Mirvac, which manage separate private equity real estate funds using their integrated funds management platforms, and in some cases use their development and construction capabilities to generate assets for their funds.

Unlike the global PE firms, Australia’s traditional PE 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.

Real estate private equity operations in Australia are characterised by 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-add investments and alternative real estate classes. Investment vehicles vary in size ranging from sub-A$100 million in real estate assets to over A$10 billion.

Real estate private equity managers adopt a variety of approaches to structuring investments, depending on the type of asset, the manager’s position in the market, the type of investors whose funds are managed and the level of oversight which investors wish to exercise. These range from joint ventures, through clubs or syndicates, to the wholesale funds more commonly used for investment in other real estate asset classes.

Typically, externally managed unit trust structures are used 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 listed REITs, unit trust structures provide flow-through tax treatment where passive assets are held. 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 passive nature of the investments.

Offshore real estate PE firms typically invest into Australia real estate assets through unit trusts, leveraged corporate structures, or (where suitable) direct ownership of underlying assets. Their offshore fund structures reflect those typical of the jurisdiction where such funds are based.
IV  TRANSACTIONS

i  Legal framework and deal structures

Legal framework

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 the trusts, including detailed rules about matters such as the trustee's 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). 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 is the case for all listed REITs.

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 responsible entity, as well as meeting minimum net tangible assets requirements. There are alternatives, such as engaging professional trustee companies to perform the responsible entity function.

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, although they retain legal responsibility, trustees will delegate the performance of 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 fund raising, takeovers and other control transactions, 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 providing for continuous disclosure of materially price sensitive information, rules relating to corporate governance, and rules restricting investor dilution, 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 of the Australian legal framework for REITs that can affect transaction execution include the following.

Separate ownership of a REIT’s trustee and manager from REIT securities, as is the case for externally managed REITs, can cause divergences between the interests of shareholders in the trustee and manager and those of the REIT’s security holders (for example, where a transaction would result in the trustee losing management of the REIT and associated fee streams). This can place directors and executives of the trustee in a position of conflicting interests.

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5 See Chapters 5C and 7 of the Corporations Act.
6 Section 911A, Corporations Act.
7 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.
responsibilities and interests. In practice, this is typically managed through governance protocols including establishing an independent board committee to manage the relevant transaction from a REIT security holder perspective (with conflicted executive directors abstaining).

The trustee of a registered REIT (as 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 which affect the REIT’s trustee.

**Deal structures**

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.

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. The most common techniques to acquire control of a listed REIT within this framework are an off-market takeover bid regulated by the Corporations Act or a scheme (see Section IV.ii for more information about acquisition terms used in takeover bids and schemes).

As takeovers regulation under the Corporations Act does not apply to unlisted REITs, a buyer might engage directly with individual REIT security holders to acquire their securities on whatever terms are agreed, subject to transfer restrictions in the REIT’s constituent documents (see Section IV.ii, below, for more information about acquisition terms). Trust schemes may also be used in this context, and 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 REIT’s trustee. Under the Corporations Act, the responsible entity of a registered REIT can be replaced by a simple majority resolution of unitholders present and voting for a listed REIT or by a simple majority resolution of all unitholders entitled to vote, whether or not present, for an unlisted REIT. Constitutions of unregistered REITs may also provide unitholders with similar rights to remove the trustee by resolution. While relatively low voting thresholds apply, in practice it is rare that a responsible entity is forcibly removed in this way. Typically, the challenge is demonstrating to existing investors that the replacement responsible entity offers a more compelling proposition than the incumbent.

**ii  Acquisition agreement terms**

**Takeovers and 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:

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8 Section 253E, Corporations Act.
9 Section 606, Corporations Act.
10 Section 601FM, Corporations Act.
a limitations to offer terms apply (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, consideration cannot generally be reduced) and ASIC consent is generally required to withdraw an offer;
b 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;
c the target prepares a target’s statement containing recommendations of the directors of the target’s trustee and other material information known to the target, which must also be lodged with ASIC and the ASX; 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).11

Under a trust scheme, the target trust’s unitholders vote to amend its constitution to enable all of the units in the target trust to be transferred to the bidder. 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 scheme process involves:
a a disclosure document is provided to the security holders who are required to vote on the proposal, including details of the offer and acquirer, information about its 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 the trust scheme is binding on all security 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; and
c court approval of the trust scheme is not mandatory (unlike company schemes of arrangement), although ‘court directions’ to the trustee are sometimes sought to the effect that the trustee would be justified in implementing a trust scheme if approved by the requisite unitholder majorities.

Acquisition of a stapled trust and company requires inter-conditional trust schemes and company schemes for each entity comprised in the stapled entity. Schemes may also be used to implement the stapling of the securities of two entities so that they trade together (rather than one entity acquiring another’s securities). In these circumstances a vote of the unitholders in both entities is usually required.

For both schemes and takeovers, the consideration may comprise cash or scrip or a combination of the two. Tax considerations, including availability of roll-over relief from capital gains tax, will often be a key factor in determining the consideration offered (see Section IV.v).

11 See Chapters 6 and 6A, Corporations Act.
Implementation agreements between the target and bidder are common for friendly takeover bids and schemes. They contain typical deal protection mechanisms, including:

- conditions precedent to implementation and the bidder’s and target trustee’s obligations in relation to implementation of the transaction process;
- 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;
- 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); and
- generally limited warranties and indemnities which effectively cease to operate on implementation of the transaction.

Bidders will often seek due diligence access before entry into an implementation agreement. Whether the 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 schemes as the bidder cannot vote their securities in a scheme. However, it is possible to obtain options or enter into voting agreements for up to 20 per cent of a target if structured appropriately. Stakes of 5 per cent or above 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 formal auction process may be run with specified timelines for expressions of interest, selection of preferred bidders, due diligence and binding bids. This is generally the case for transactions involving the sale of large asset portfolios, with investment banks typically engaged to coordinate the sales process. For smaller real estate portfolios sellers may conduct the sale process with the assistance of commercial real estate agents. For sales of unit-holdings in wholesale funds, investors will usually conduct their own sale process, or the trustee may be empowered to do so on the selling unitholders’ behalf under the relevant fund constitution.

The primary sale document is typically a unit sale agreement. Key terms 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 will be 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 unitholders to control the trustee’s actions) and steps to enable the change of trustee following completion.

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

13 Section 671B and Part 6C.2, Corporations Act.
iii Hostile transactions

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

More recent examples in the Australian market include the competing scheme proposals by Blackstone and Oxford Properties for the Investa Office Fund in 2018, the competing bids by 360 Capital Industrial Fund and NEXTDC Limited for the Asia Pacific Data Centres Group in 2017, the bid by Growthpoint for the GPT Metropolitan Office Fund in 2016 and 360 Capital’s bid for the Australian Industrial REIT in 2015.

For a hostile bidder, the preferred method is generally an off-market takeover bid, as the scheme process is 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 to hostile public markets transactions generally, including:

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

b relatively high compulsory acquisition thresholds – generally the bidder will need to acquire at least 90 per cent of the bid-class securities;

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). Relevantly as the responsible entity of a listed REIT can be replaced by a 50 per cent majority vote of unitholders, this can 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 Australian Industrial REIT);

d potential approaches to the Australian Takeovers Panel on aspects of the bid which can affect deal timing – for example, in the 360 Capital bid for Australian Industrial REIT, 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 for 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 requirement that any action be for a proper purpose and in the interests of the REIT’s security holders. ASX listing rules also prohibit certain issues of securities within three months of a takeover announcement. The Takeovers Panel may declare target actions to frustrate a current or pending bid as unacceptable, and require them to be unwound or suspended until approved by target security holders. 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. US-style takeover defence arrangements, such as poison pills, are not available to target directors of listed entities in Australia.

**iv Financing considerations**

Financing approaches for Australian real estate M&A and private equity transactions are primarily influenced by the type of transaction and the financing arrangements already in place for the target.

The cost of debt funding for real estate transactions has been trending higher in recent times. While appetite for good credits remains, domestic Australian banks have reduced their exposures to certain sectors, such as construction and development financing for large residential developments, largely in response to a perceived oversupply of inner city apartment developments in some Australian state capital cities. The importance of alternate funding sources has increased in light of the more subdued lending appetite of domestic banks, and funding from non-bank sources is becoming more prevalent.

**Funding types and sources**

Financing for real estate M&A is broadly divided into:

- **Investment finance**, or acquisition finance, which involves financing the acquisition of individual real estate assets, specific portfolios or the acquisition of securities in a target REIT, usually on a senior secured basis; and

- **Portfolio or ‘corporate’ finance**, which involves financing for a REIT to be used for general purposes, often including ‘bolt-on’ acquisitions, typically on a senior debt syndicated basis, but more recently also including a mix of bank and capital markets debt.

Investment finance typically comprises senior debt, which is typically limited recourse debt (with recourse limited to the assets being acquired) provided by one lender or a syndicate of lenders. Senior lenders typically take first-ranking security over key assets to secure the senior debt. Senior lenders will typically require the parent or sponsors of the borrower to contribute equity to the borrower in the form of equity or deeply subordinated debt, which is contributed before senior debt and any external mezzanine debt.

The majority of real estate M&A transactions are financed using senior debt provided by at least one of the Australian domestic banks. There is also increasing appetite from offshore investors buying into the Australian real estate market. As a result, an increasing number of transactions are being financed by senior debt from offshore banks, particularly Asian banks supporting the investment of their customers into the Australian market, and from life funds and specialised investment funds.

Mezzanine or subordinated financing has been most commonly used for development financing, particularly where the sponsors are unable to fund the equity required to achieve the loan to value ratio, debt to equity ratio or cost to complete tests imposed by the senior lenders. However, a trend is emerging for mezzanine debt to be used for investment finance, particularly as loan to value ratio requirements of senior debt lenders tighten. Typically, the

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

Australian domestic banks have been reluctant to accept capital structures with multiple tiers of debt, partly because of the intercreditor rights being sought by mezzanine lenders (including rights to enforce, standstill periods and restrictions on senior refinancing) and the practicalities of enforcement. However, more recently, senior lenders have become more willing to accept lenders providing mezzanine debt at the holding entity level. These instruments, which are structurally subordinated to senior debt, often feature ‘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.

Debt capital markets (bonds, notes, private placements, and other debt securities) have been used in portfolio financings 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 larger REITs more recently.

Security

Typically, security is required by senior and mezzanine lenders for investment finance. Senior lenders will require first ranking security, with mezzanine lenders receiving second-ranking security over the same assets. The priority of the securities and rights of the mezzanine lenders to enforce their second-ranking security will be regulated by inter-creditor arrangements. Lenders usually require:

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

b security over the units or shares in the borrower, which, among other matters, restricts the parent’s ability to deal with or encumber those units or shares without the lenders’ consent.

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

Portfolio financing is either secured against the assets of the REIT vehicle or unsecured, depending on the creditworthiness of the borrower and gearing of underlying investment vehicles. Whether or not security is provided, it is supported by guarantees and negative pledges from all entities comprising the investment vehicles.

There is a current trend for larger REITs 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. Typically, the margins and fees for secured group financings are lower than for unsecured group financings, but there is less freedom allowed to the entities comprising the investment vehicle under the terms of the financing documents. While there is typically more flexibility provided than in investment financing, there are still the usual ‘security’ style covenants.

Unsecured portfolio financings typically involve a combination of syndicated bank debt 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 of which all of the financiers obtain the benefit. Typically, the financing is provided on a ‘corporate’ style basis which offers more flexibility and a less stringent covenant package.
Terms generally

Recently, terms have been imported into real estate financing from the broader leveraged finance market, including the loosening of general covenants and use of materiality qualifiers. Recent trends also include the use of a ‘certain funds regime’ for investment financings, and an ‘equity cure’ for breaches of financial covenants (such as the loan-to-value ratio) across property financings generally.

Tax considerations

Holding structures

Most REITs are structured as managed investments trusts (MITs) (or seek to include a 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. Also, the trust cannot control the conduct of a trading business.\(^\text{15}\)

The key benefits of accessing the MIT regime are:

\begin{enumerate}[a]
\item for non-resident investors, lower withholding tax rates can apply to distributions of income by a MIT throughout the life of the investment, and also on any gain on disposal;\(^\text{16}\) and
\item for Australian-resident investors, investments made by a MIT automatically become subject to the capital gains tax (CGT) rules (and are not taxed on revenue account) where the MIT makes a ‘CGT election’.\(^\text{17}\) This enables access to the CGT discount and CGT rollover relief.
\end{enumerate}

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

Tax law changes relevant to stapled structures

The Commonwealth government recently reviewed the use of MITs in stapled structures.\(^\text{18}\) The government was concerned that some land-rich businesses were being split into a land-holding entity and an operating entity, with the relevant land leased to the operating entity. The land-holding entity would be structured as a MIT, which would entitle investors to access concessional tax treatment. The government concluded that, at least for non-residents, income derived from such arrangements should be subject to the full corporate rate of tax.

The review led to amending legislation designed to limit access to the lower MIT withholding tax rates where MITs are used as part of a stapled structure.\(^\text{19}\) Under the new

\begin{enumerate}[\text{15}]
\item For the requirements to be a MIT, see Subdivision 275-A of the Income Tax Assessment Act 1997 (Cth).
\item Subdivision 12-H to Schedule 1 of the Taxation Administration Act 1953 (Cth).
\item Subdivision 275-B of the Income Tax Assessment Act 1997 (Cth).
\item See Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019.
\end{enumerate}
rules, subject to some exclusions and transitional arrangements, net income derived by MITs from operating entities within a stapled group (for example, rent paid by the operating entity to the MIT) will generally be subject to 30 per cent withholding tax when distributed to non-residents.

The proposed changes should not materially affect use of stapled structures to hold and manage traditional classes of real estate asset (office, retail and industrial); however, use of MITs in stapled structures for certain alternative real estate investment classes, where the real estate is integrated with a trading business (for example, hotels, student accommodation, retirement living and aged care) will likely be affected.

**Proposed corporate collective investment vehicle regime**

Also, tax law changes are in the process of being implemented so that funds established as companies and limited partnerships are taxed on a similar basis to trusts.20 These reforms, are intended to facilitate use of investment vehicles commonly used overseas in the Australian market, and complement commencement of the Asia Region Funds Passport. However, differences between the proposed tax treatment of these vehicles under draft legislation released in December 201721 and current tax treatment of trusts may mean that these vehicles will remain less attractive than trusts.

**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 CGT event (on capital account). The distinction determines if a security holder can access the CGT discount and CGT rollover relief, and ultimately affects the amount of tax a security holder pays on any gain on disposal.

An investment is generally considered to be held on revenue account where it was made for a profit-making purpose through sale of the interest, rather than for the 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 (being cash consideration and the market value of any securities or other assets received on disposal)22 received by a security holder exceeds the security holder’s cost base (generally, the original acquisition consideration plus incidental costs, less tax-free capital distributions on units)23 in their 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 their investment.

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23 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). Capital distributions paid on units may be sheltered from tax.
Generally, unitholders 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.24

Australia-resident individuals, superannuation funds and trusts that have held an investment for more than 12 months, are entitled to reduce their CGT gain 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.25

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 greater interest in the relevant REIT or company throughout a 12-month period that began no earlier than 24 months before that time; or

b. not more than 50 per cent of the value of the REIT or the company derives from interests in Australian real property.26

As REITs generally hold interests in Australian real property, only the first test above would be relevant to non-resident securityholders. In some circumstances, companies stapled to REITs do not meet the 50 per cent real estate threshold (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), and so both tests can be relevant in working out if any gain on the sale of shares in that company is subject to CGT.

Availability of scrip for scrip rollover relief from CGT

Scrip for scrip rollover relief from CGT may be available where units or shares are disposed in exchange for units or shares.27 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.

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 (e.g., by a stapled group).

The acquiring entity must become owner of 80 per cent or more of the target entity. Often the threshold for a scrip-based takeover bid to become unconditional is lower. In such cases, if the 80 per cent threshold is not met, target security holders who accept the offer do not receive rollover relief.

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24 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).
Where the transaction is a unit for unit transaction, each trust must be a ‘fixed trust’. As the law as to what constitutes a fixed trust is unclear, the Commissioner of Taxation’s discretion to treat trusts as ‘fixed trusts’ has almost always been sought. However, under recent changes to the MIT rules, trusts that are MITs may be automatically deemed to be a ‘fixed trust’ if certain requirements (including the making of an irrevocable election to be an ‘attribution MIT’) are met.

The offer must be on substantially the same terms to all security holders in the target. Significant security holders cannot be treated differently to others.

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 exceed the 10 per cent threshold (and thus be taxable Australian property 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.

**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 counterfactual (that is, what the structure or transaction would have been without the tax avoidance purpose). 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 for transaction steps).

**Stamp duty and land tax**

Acquisitions of Australian real estate assets may attract state or territory stamp duty. Duty in relation to acquisitions of commercial land (other than in South Australia, where duty on commercial land has been abolished from 1 July 2018) generally ranges from 4.5 per cent to 5.95 per cent of improved land value (or purchase consideration if higher) depending on which state or territory the land is located.

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

Higher duty rates apply to acquisitions of residential property in certain circumstances. All Australian states (excluding the territories) have imposed surcharges ranging up to 8 per cent on foreign acquirers of interests in residential real estate (and primary production land in Tasmania).

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 1.1 and 3.7 per cent (usually of the unimproved value of the land) depending on the state or territory in which the land is located. In addition, for foreign owners a 2 per cent surcharge applies to residential land in New South Wales, a 0.75 per cent surcharge applies to land in the ACT, and a 1.5 per

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A higher A$1.154 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. 35

The legislation provides a 30-day period, from the date lodgement fees are paid, within which a decision whether or not 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 FIRB receiving input in relation to proposed acquisitions from a range of government agencies, including the Australian Taxation Office, the Critical

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30 Foreign Acquisitions and Takeovers Amendment (Exemptions and Other Measures) Regulation 2017.
31 Section 81, 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.
32 See Sections 52(5), (6), Foreign Acquisitions and Takeovers Regulation 2015 (Cth). For example, land under ‘prescribed airspace’, which previously applied to most land in Australia’s capital cities will no longer be subject to the lower threshold.
33 At Section 52(4), Foreign Acquisitions and Takeovers Regulation 2015 (Cth).
34 Section 52(1), Foreign Acquisitions and Takeovers Regulation 2015 (Cth).
35 Section 52(5), Foreign Acquisitions and Takeovers Regulation 2015 (Cth). Countries for which the higher threshold applies are Canada, Chile, China, Japan, Mexico, New Zealand, Singapore, South Korea, the United States and Vietnam. 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.
Infrastructure Centre (where applicable) and national security agencies before providing its advice to the Treasurer. Approval is required before the acquisition can complete. Failure to obtain necessary approvals can lead to divestment as well as criminal sanction.

vii 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 47 per cent for trust income distributions). Lower withholding rates may apply in certain circumstances pursuant to double-tax agreements.

Concessional withholding tax applies to income distributions by trusts that satisfy the conditions for being characterised as a ‘Managed Investment Trust’ for tax purposes: see Section IV.v 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 leaseback 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 (e.g., Shopping Centres Australasia Property Group spun off by Woolworths in 2012 and the Asia Pacific Data Centres Group spun off by NextDC in 2013);

b externally managed ASX-listed REITs, with the manager being the corporation that was spinning off its real estate assets (e.g., the BWP Trust spun off by Wesfarmers in 1998, the Viva Energy REIT listed in 2016);

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;

d PE real estate fund led acquisitions of corporate real estate portfolios (Allied Pinnacle in 2017); and

e the establishment of special purpose wholesale funds to hold and lease-back corporate real estate (Telstra in 2019).

36 Sections 77, 82, Foreign Acquisitions and Takeovers Regulation 2015 (Cth).
VI OUTLOOK

Although listed REITs, particularly those exposed to office and industrial real estate, have performed strongly and listed REITs have raised over A$4 billion in equity since the start of the year, 2019 has not seen significant REIT IPO activity. Nevertheless, strong investor appetite for yield stocks is expected to drive increased REIT IPO activity in the coming year.

The listed REIT market is expected to continue experiencing consolidation over the coming year, particularly among smaller REITs as they seek scale in an environment of increasing competition for direct investment opportunities, as well as further real estate PE-led M&A activity, led primarily by offshore real estate PE firms and real estate funds.

As the current real estate cycle continues to move into the late stage of the cycle, corporate real estate activity (including separation and spin-offs) is expected to increase as is investor appetite for real estate-backed debt.
I OVERVIEW OF THE MARKET

In 2018, Austrian general M&A activity decreased slightly in terms of the number of transactions announced: a total of 324 statistically relevant M&A transactions with Austrian participation were reported, as compared to the 345 transactions that took place in 2017 and 345 transaction in 2016. In addition, the general transaction volume substantially decreased from €14.7 billion in 2017 to €7.9 billion in 2018 (as compared to €10.7 billion in 2016), which is mainly due to the lack of high-volume deals above €1 billion and global political insecurity resulting from the legal uncertainty concerning Brexit as well as the looming trade war between the US and China.

The most active sector in Austria in 2018 has been the industrial sector, leading in terms of the number of statistically relevant transactions (81). The real estate and construction sector with 72 relevant transactions remains on top in terms of the total transaction volume (€2.4 billion). However, the number of real estate acquisitions has declined by 14 counts as compared to 2017 and the total volume is €6.6 billion lower than the year before. Nevertheless, from a general perspective, the demand for Austrian real estate remains stable because of the country’s generally stable political and economic framework, which is additionally fostered by extremely low interest rates and available financing. Even though real estate prices have increased significantly over the past few years, Austria is still considered a key place for non-speculative real estate investments. In particular the demographic development and expected urban expansion (with Vienna having been consistently ranked as one of the world’s best cities to live in) have resulted in demand that exceeds availability. Therefore, real estate investments also appear attractive to foreign institutional investors. Consistent with the past, Germany plays a key role in Austrian inbound M&A activity with 32.5 per cent of all acquisitions of Austrian companies by foreign investors having been made by German investors. Another 39.8 per cent of the acquisitions were concluded by investors from other European countries.

In 2018, the largest real estate M&A transaction was the acquisition of a 26 per cent stake in CA Immobilien Anlagen AG by Starwood Capital Group, with a transaction value of €757.9 million.

The increasing appetite among private equity investors, driven by notable private equity transactions, the share of financial investor-driven transactions rose in 2018 (from 20 to 27 transactions). In Austria itself, private equity are mainly driven by unclassified investors followed by governmental agencies, insurance companies and banks.

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II RECENT MARKET ACTIVITY

i M&A transactions

Below is a short summary of four of the most significant recent real estate M&A transactions in the Austrian market.

Acquisition of stake in CA Immo by Starwood

US investor Starwood acquired a stake corresponding to approximately 26 per cent in CA Immobilien Anlagen AG (CA Immo) for a total price of €757.9 million from Immofinanz AG, an Austrian-based and listed real estate stock corporation. The transaction was closed in Q3 2018. Originally CA Immo and Immofinanz AG had agreed in 2016 to merge and create a property heavyweight, but the plan fell through in 2018 after pressure from an activist investor. Shortly after that, Starwood launched its own bid to buy up to 26 per cent in CA Immo and up to 5 per cent in Immofinanz AG, which failed in the first run. However, the US firm got a second chance when Immofinanz AG put its stake on the bloc.

Acquisition of Kika/Leiner by Signa

Austrian real estate company SIGNA Group acquired Kika/Leiner, Austria’s second largest furniture chain in June 2018 for a total price of €500 million. The acquisition included the operative retail business of Kika/Leiner with its approximately 6,500 employees as well as the approximately 100 properties in Austria and Central and Eastern Europe.

Acquisition of ‘Marina Tower’ by Buwog

The German-Austrian residential real estate group Buwog acquired a majority stake in the development companies of ‘Marina Tower’, a residential tower planned in the second district of Vienna (51 per cent in Marina Tower Holding and 50 per cent in Marina City Entwicklungs GmbH) in July 2018 for a total price of €220 million. The construction of the 39-storey tower is scheduled for completion in 2021.

Acquisition of parts of the building complex ‘The Brick’ by Wiener Städtische Versicherung

The Austrian insurance company Wiener Städtische acquired in November 2018 two of three components of the multifunctional building complex ‘The Brick’ located on Wienerberg with a total usable space of approximately 21,300 square metres for a total price of €100 million from Soravia Group. The acquired buildings will mainly become the future headquarters of the world’s largest producer of bricks Wienerberger AG. The construction is scheduled for completion in 2020.

ii Private equity particularities

The number and volume of Austrian private equity and venture capital funds is well below the European average. Nevertheless, transactions by private equity investors rose from 20 to 27 deals in 2018 as compared to 2017. Notwithstanding such increase of transactions, the Austrian Private Equity and Venture Capital Organisation (AVCO) reported a decrease in the private equity fundraising to €160 million. The allocation between private equity investors may be summarised as follows:

- unclassified: 45.4 per cent (2017: 13.8 per cent; 2016: zero per cent);
- governmental agencies: 21.8 per cent (2017: 33 per cent; 2016: 100 per cent);
Austria

insurance companies: 9.7 per cent (2017: 11.7 per cent; 2016: zero per cent);
banks: 9.4 per cent (2017: 28.8 per cent; 2016: zero per cent);
private individuals: 6.6 per cent (2017: 3.8 per cent; 2016: zero per cent);
corporate investors: 4.7 per cent (2017: 6.9 per cent; 2016: zero per cent); and
family offices: 2.4 per cent (2017: 0.5 per cent; 2016: zero per cent).

Fund of funds (2018: zero per cent; 2017: 1.4 per cent), Pension funds (2018: zero per cent; 2017: zero per cent), capital markets (2018: zero per cent; 2017: zero per cent), endowments and foundations (2018: zero per cent; 2017: zero per cent), other asset managers (including PE houses other than fund of funds) (2018: zero per cent; 2017: zero per cent) and sovereign wealth funds (2018: zero per cent; 2017: zero per cent) were not relevant to the Austrian private equity market.

The SME Financing Act 2017, which aims to establish a more advantageous taxation system for investors, was published on 26 July 2017. Accordingly, dividends of up to €15,000 annually are exempt from capital gains, resulting in a maximum tax relief of €4,125 per investor per calendar year. Further, after federal elections in 2017, the Austrian government declared in its government programme (which has political rather than legal relevance) its intention to strengthen the private equity sector as a part of its strategy to bolster the economic position of Austria including by emphasising its intention to incentivising venture capital as an overall economic strategy. Due to the government crisis and anticipated elections in September 2019, it remains to be seen whether the new government will continue to pursue this goal.

III REAL ESTATE COMPANIES AND FIRMS

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

While real estate investment trusts (REITs) are common to many jurisdictions, this structure has not yet been incorporated into the Austrian legal system.

Choice of company structure is highly tax driven. For the purposes of indirect real estate investments in Austria, there are available general stock corporations that operate as real estate operating companies (REOCs) (such as Immofinanz, Conwert and CA Immobilien), as well as open and closed-ended real estate investment funds. Profits of Austrian REOCs are subject to Austrian corporate income tax at a flat rate of 25 per cent. Profits distributed to investors, as far as natural persons are concerned, are additionally subject to Austrian capital gains tax at a flat rate of 27.5 per cent. This is the reason the majority of the Vienna-listed real estate stock corporations do not distribute dividends to their investors but rather tend to retain profits for reinvestment. Investors merely profit through the appreciation of the stock, which is subject to general market fluctuations. Therefore, certain investors consider this reinvestment policy to be a disadvantage.

As an alternative to investments in public real estate stock corporations, the legislator established a new real estate funds investment vehicle in 2003 through the Austrian Real Estate Investment Fund Act, with a view to providing tax advantages comparable to those of REITs in other jurisdictions. While shares in an Austrian real estate investment fund are not allowed to be offered on a stock exchange, they are obliged to pay out dividends upon the shareholder’s request (to the extent provided by the regulations of the fund concerned, and with certain exceptions allowing dividends to be carried forward for up to two years). The fund itself is not subject to corporate income tax; effective distributions as well as fictitious
distributions of retained profits are subject to income tax at shareholder level. It is important to note that not only balance sheet profits derived from real estate, such as income from rent, but also 80 per cent of the increase in value of invested real estate is subject to taxation (even if not yet realised). For this purpose, the total asset value of a real estate fund has to be determined at least once a year by two independent experts. The related costs of yearly valuation and the taxation of unrealised profits are considered to be major disadvantages, especially if the fund is not able to generate an adequate return on investment.

ii Real estate PE firms – footprint and structure

Real estate private equity firms investing heavily in the Austrian market are currently rare. The main vehicles used for private equity funds established in Austria are limited partnerships or limited liability companies, as well as joint-stock corporations. Each of these types of entity has a separate legal personality, but partnerships are transparent for tax purposes.

However, most private equity firms active in Austria with significant investments are located offshore or are founded under laws granting private equity companies a selective tax advantage. Since the introduction of the AIFMG, most private equity funds established in Austria qualify as alternative investment funds under this Act. The formation of an alternative investment fund requires the prior approval of, and registration with, the Austrian Financial Market Authority. Funds pursuant to the Austrian Investment Funds Act, as well as funds qualifying under the Austrian Real Estate Investment Funds Act, are not captured by the AIFMG.

IV TRANSACTIONS

i Legal frameworks and deal structures

As in other jurisdictions, real estate acquisitions in Austria may differ both in the structuring of the sale process and in the deal structure itself.

The structuring of an investment for the acquisition of property is based on various economic, fiscal and legal considerations, whereby investments may generally be structured as asset or share deals. The advantage of an asset deal is that the investor may be better aware of the transaction scope (particularly in relation to the potential tax or other liabilities of a pre-existing company), whereas a share deal is generally tax advantageous as, with the correct structuring, real estate transfer tax can be avoided. This is possible, as an asset deal generally triggers Austrian real estate transfer tax at a rate of 3.5 per cent of the consideration, whereas only a transfer of at least 95 per cent of the shares in a company holding Austrian real estate is subject to real estate transfer tax. In light of this, it has become common practice to implement a share deal structure with two acquiring entities that must each acquire more than 5 per cent in the target company (e.g., a 94 per cent/6 per cent structure). Furthermore, a share deal will not result in a change in the ownership of the property itself, which means that registration fees of 1.1 per cent of the market value of the real estate may also be avoided.

Real estate acquisitions through asset or share deals are not subject to a special legislation regime, but rather to various civil, corporate, tax, stock exchange and antitrust laws. The relevant provisions on asset deals can be found in the Austrian Commercial Code, as well as the Austrian General Civil Code. Mergers, demergers and transformations, on the other hand, are regulated in the Stock Corporation Act, the Act on Limited Liability Companies...
as well as specific laws. Listed companies, as well as the transactions in listed companies, are additionally regulated by the Austrian capital market laws. Acquisitions by foreigners are often subject to approvals by regional land authorities (see Section IV.v).

The following legal forms are typically used as real estate holding entities and acquisition vehicles (if an Austrian entity is chosen at all):

a Limited liability companies (GmbH) offer flexibility and can be established by legal entities or by one or more individuals, who are generally not personally liable for the company’s liabilities. The minimum share capital amount is €35,000, of which at least €17,500 must be paid in. Since 2014, there is an option to limit share capital to €10,000 (of which at least €5,000 must be contributed) for up to 10 years.

b Joint-stock corporations (AG) are legally liable entities, the shareholders of which participate in the share capital divided into shares by means of contributions, without being personally liable for the company’s liabilities. The minimum capital stock is €70,000. The ongoing legal structure costs of an AG are higher than for a GmbH. In addition, they offer less flexibility – except in relation to share transfers.

c Partnerships can be incorporated by at least two parties as a general partnership (OG) or a limited partnership (KG). The difference between an OG and a KG is that in a KG at least one partner has limited liability, whereas all partners of an OG are personally fully liable. In addition to the flexibility of partnerships (which is even greater than that of a limited liability company), their main advantage is tax transparency, which allows the direct allocation of profits and losses to partners for tax purposes.

ii Acquisition agreement terms

In Austria, there are statutory rules on warranties and damages as well as indemnities. In general, a purchaser is entitled to remediation or exchange of the deficient object in the first instance. In the second instance, the purchaser has the right to request a price reduction or to rescind the contract. Unless otherwise agreed by the parties, the warranty period is two years for movables and three years for real estate (with a period of up to 30 years applying for legal defects). The tort regime for damages arising from negligence on the part of the seller applies in parallel.

The contractual regime will seek to replace these statutory rules to the greatest extent possible and will usually exclude rescission of the agreement and limit the buyer to claiming damages, which are contractually defined and limited in scope and amount. Certain mandatory provisions may still apply and override contractual limitations and exclusions of claims, such as claims based on deceit or collusion. Caps, floors and baskets defining and limiting the amount of damage claims are generally consistent with international practice and usually determined by the bargaining power of the buyer and the seller.

Conditions precedent to closing regularly involve regulatory approvals such as merger control and the approval of regional land authorities, particularly in the case of non-EU purchasers (see Section IV.vi). Additionally, conditions precedent may relate to contractual partners waiving termination rights in the event of change of control. Material adverse changes clauses are heavily negotiated but frequently incorporated into the transaction documentation.

In line with international practice, covenants between signing and closing will usually relate to limitations on the conduct of business until closing (ordinary course) and
information obligations on the buyer as to business development, and usually also provide for a prohibition of dividend or other payments to the seller by the target between signing and closing.

In the event of a portfolio sale (potentially also involving multiple jurisdictions) in the form of an asset deal, typically a framework agreement governing the legal terms is negotiated. Short transfer deeds relating to each individual land plot will then have to be executed at the closing of the transaction allowing the purchaser to register the ownership with the applicable land register. These documents generally need to be notarised.

### iii  Hostile transactions

A hostile takeover of a public real estate company in Austria has not occurred yet.

### iv  Financing considerations

Generally, real estate financing is provided by banks via loans. Restrictions on who may provide financing in relation to real estate transactions mainly stem from banking regulations that restrictively regulate the commercial granting of loans (including within groups). Typically, mortgages serve as collateral for real estate financings. In the case of share deals, pledges over the shares of the borrower, pledge of movables, accounts pledges, assignments of receivables or rights under any major contracts are also considered. To create a mortgage, pledgor and pledgee must execute a mortgage agreement in writing, with the signatures being notarised. Generally, both fixed-amount mortgages (securing a specific amount) as well as maximum amount mortgages (which may be recurrently used under a specific relationship) are possible under Austrian law. The mortgage is only established upon its registration with the land register, which triggers a registration fee (see below).

### v  Tax considerations

In the event of a sale or acquisition of real estate in Austria, the following taxes need to be taken into consideration.

#### Real estate transfer tax

The following are subject to Austrian real estate transfer tax:

- the acquisition of Austrian real estate; and
- the consolidation in the hand of a single shareholder of more than 95 per cent of the shares in a company owning Austrian real estate.

The taxable base for the determination is the value of the consideration. As a rule, this is the purchase price or at least the market value of the real estate (if the purchase price is lower).

Real estate transfer tax generally amounts to:

- 3.5 per cent in the case of an asset deal; and
- 0.5 per cent in the case of a consolidation of more than 95 per cent of the shares in a company.

Further, transfers without consideration (i.e., donations) are subject to real estate transfer tax at a progressive tax rate ranging from 0.5 per cent to 3.5 per cent.
Real estate profit tax
The profits from the sale of real estate are subject to a real estate profit tax, which is generally subject to a flat tax of 30 per cent, provided that a flat tax rate of 25 per cent applies to all profits generated by profits from corporate entities (including from the sale of real estate).

General corporate income tax
Profits from the sale of real estate by a corporate entity are subject to corporate income tax at a flat rate of 25 per cent (see above).

Registration fee
In addition to real estate transfer tax, a registration fee amounting to 1.1 per cent of the market value of the property applies for entering the right of ownership in the land register. For the registration of mortgages, an additional 1.2 per cent of the mortgage amount must be paid.

Stamp duty
The execution of a purchase agreement and the contemplated acquisition of real estate does not generally trigger stamp duties.

VAT
Real estate transactions are generally not subject to VAT. However, if the selling party is an entrepreneur, they may opt to treat the sale of real estate as VAT taxable at a rate of 20 per cent. Entrepreneurs typically take this option into consideration if they have reclaimed input tax regarding the real estate (which would otherwise have to be refunded) within the past 10 years for real estate acquired prior to 1 April 2012 or the past 20 years for real estate acquired after such date.

vi Cross-border complications and solutions
Under the land transfer regulations, the transfer of property rights to non-Austrian resident investors may require an approval. In this respect, each Austrian federal province has its own legal framework defining the applicable restrictions and approval process. If the necessary approval is not obtained, a transfer of ownership cannot be registered in the relevant land register and the contemplated transaction cannot be carried out (as real estate ownership is generally obtained only through registration of the new owner in the land register). Persons and corporate bodies of EU Member States or signatory parties to the European Economic Area agreement have the same status as domestic persons and corporate bodies. For certain federal provinces, the creation of an Austrian holding structure is sufficient for fulfilling the requirements of the applicable land transfer regulations.

V CORPORATE REAL ESTATE
Even though a separation of corporate real estate from operating companies seems to occur in the Austrian market in certain cases (including for purposes of real estate financings), the number of transactions does not indicate that this will become a major trend.
VI OUTLOOK

The general market outlook for real estate investments in Austria is positive; the reasons being the consistently low interest rate and therefore cheap financing, and the positive economic outlook due to the low unemployment rate and predicted economic growth above the eurozone average. Moreover, demand should be steady as the general consumer climate is positive because of relatively low oil prices and growth of the total population through immigration. Therefore, the total volume of transactions will depend on supply, with the rate of return being expected to decline even further.

Of the total transaction volume in the real estate and construction sector in Austria, institutional residential investments accounted for more than €1 billion, making them the most popular asset class for the first time, together with office spaces. Due to the well-filled pipeline in large-volume residential construction, this trend will most likely continue in 2019. Consequently, a concentration of investment activity on residential properties is also expected for the investment year 2019. On the one hand, this is due to the continued attractive real estate market, which is attracting institutional investors from Germany who are unable to find sufficient products eligible for investment on their domestic market. On the other hand, the yield levels of commercial and residential real estate have converged considerably in recent years. Last year, more than half of the German transaction volume was already invested in residential real estate in Austria.

However, the amendment to the Vienna Building Code, which came into force at the beginning of 2019 with the aim to foster affordable and environmentally friendly living, but also to the improved protection of historic buildings, could lead to lower residential construction activity from 2021 onwards and thus restrict the investment offer on the primary market of Vienna in the long term. As the majority of institutional residential investments are carried out as forward transactions, this development could become noticeable in 2020.

An amendment to the Housing Community Act planned for 2019 will allow tenants to purchase state-subsidised apartments built by non-profit building associations after a rent period of five years already (instead of the previous 10-year period). In the long run, the proposed amendment would mean that more real estate transactions could take place, and more state-subsidised apartments would have to be built to maintain the level of affordable rental housing.

As a result, the Austrian real estate market may benefit from the envisaged changes in the near future. Taking into account the general political and economic stability, investments and real estate prices are thus still expected to rise.
Chapter 4

BRAZIL

Henry Sztutman, Jorge N Lopes, Jr, Flávio Coelho de Almeida and Felipe Tucunduva van Heemstede

I OVERVIEW OF THE MARKET

Historically, Brazil's political environment has influenced, and continues to influence, the performance of the economy and the confidence of foreign investors in real estate deals in Brazil.

The 2018 Brazilian presidential elections marked the breakdown of the political dynamic, which had been in place since 2003. PT, the workers' party, led the ruling coalition from 2003 to 2016, during Mr Lula da Silva’s (2003–2006 and 2007–2010) and Ms Rousseff’s (2011–2014 and 2015–2016) administrations. Following the impeachment of Ms Roussef, her former Vice-President, Mr Temer, formed an MDB-led government (2016–2018).

In January 2019, Mr Jair Bolsonaro took office and since then has been facing some key reforms that are critical for Brazil to resume growth and sustain economic and social stability.

The first key challenge for Mr Bolsonaro's government is the implementation of reforms to the public pension system, whose main liabilities are around 1 million high-income civil servants, mainly from the military, as well as judges, prosecutors, congresspersons, directors and superintendents of state-owned companies and the federal police, that represent over 30 per cent of the Brazilian social security system's public deficit. In addition to social security system reform, Bolsonaro's government is also focusing on privatisation programs and fiscal policy reforms.

In summary, Mr Bolsonaro and his Finance and Economy Minister, Mr Paulo Guedes have been building a solid team, suggesting a market-oriented government.

The Brazilian real estate market appears to have been rebounding faster than expected in 2019, and therefore investors are beginning to appear more optimistic.

The Brazilian legal system is based on the Roman-Germanic tradition, meaning 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 specific circumstances, and the decision is enforceable only in relation to the parties to the dispute. In other words, court rulings serve as a guide, but are not binding on all market players.

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1 Henry Sztutman and Jorge N Lopes, Jr are partners, Flávio Coelho de Almeida is a senior associate, and Felipe Tucunduva van Heemstede is an associate at Pinheiro Neto Advogados.
From a legal perspective, the key issues in acquiring real estate in Brazil are:

- development of the most advantageous structure for the deal, taking into account such issues as liability and tax efficiency for investors;
- conveyance tax considerations;
- legal restrictions on acquisition of Brazilian real property by foreigners;
- environmental and consumer law issues;
- the impact of specific laws related to real estate development and lease activities; and
- tax and labour issues at the operating company’s level, which affect the company’s results and, by extension, investor returns.

II  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 organised as closely held companies, but a few are publicly held companies traded on B3.2

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.

FIIs 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. 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 B3’s Novo Mercado).

ii  Real estate PE firms – footprint and structure

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

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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 these 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 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. These aspects and the corresponding solutions should be considered on a case-by-case basis, in light of the tax and asset condition of each individual involved.

III 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 B3 also apply to publicly held companies adhering to specific corporate governance segments. CVM regulations also apply to investments made by FIPs and FIIs. 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 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 and 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.³ 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 regarding the property and the seller; (2) the seller’s obligation to make these documents available; (3) specific due diligence rules and timelines; (4) an exclusivity period; and (5) sometimes even 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, 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. This registration is necessary to meet the formalities inherent in this type of document; disclosure of real property conveyancing must be arranged so that it is enforceable in relation to 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 a FIP, which, in its turn, will acquire the local legal entity owner of the real estate.

Brazillian 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, as a general rule, there must be at least two partners (shareholders or members), which may be individuals or legal entities (and which do not have to 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 B3 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:

- real estate properties and rights;
- equity of real estate companies;
Brazil

c special purpose entities engaging in real estate business;
d other investment funds (FIPs, FIIs, FIDCs (i.e., receivables securitisation funds that must allocate over 50 per cent of their net worth in receivables (including those credit rights attached to underlying real estate businesses or assets)), which have an investment policy comprising activities permitted to FIIs; and
e real estate receivables certificates and other real estate backed instruments.

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

FIIs are administered by legal entities accredited by the CVM and hold fiduciary ownership of the portfolio assets. These entities, the administrators, are also liable for payment of taxes by FIIs as and when due.

FIPs

According to CVM Ruling No. 578 of 2016, as amended, a FIP must be organised as a closed-end condominium consisting of an unpersonified pool of assets (as opposed to non-Brazilian funds organised as partnerships or corporate entities) administered 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. A 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) of joint-stock companies, quotas of limited liability companies, convertible and non-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, and, except for investment by the FIP into non-convertible debentures, that is generally limited to 33 per cent of the subscribed capital of the FIP.

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 SPV structure to handle operating real estate assets was not put in place at the time of the original investment and, therefore, an SPV 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).

Notwithstanding the above, B3 issued, in 2016, procedures permitting and regulating public acquisition offerings of FIIs’ quotas. Such procedures, in practice, make hostile takeover transactions involving FIIs possible. Nevertheless, since the issuance of such procedures by B3, there has been no relevant number of hostile takeover transactions of FIIs so far.

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 immovable 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.

**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 6 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 capital gains as well as 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). 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 SPVs 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.

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4 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.

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In Brazil, corporate taxation materialises in the form of corporate income tax (IRPJ) at a rate 25 per cent,⁵ 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.

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.

⁵ 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.
**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, in the form of IRRF to be charged upon distributions to the investors, at rates varying in accordance with their legal qualification and country of residency.

Nonetheless, apart from this 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, once every six months (in June and December of each year).

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 a 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 the income by legal entities in general. A different tax treatment applies to foreign investors.

Finally, the income earned by individuals, who may be either tax residents in Brazil or abroad, from investments in FIIs is tax-exempt when:

- its shares are traded solely on a stock exchange or organised OTC securities market;
- it has at least 50 shareholders; and
- 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.

Other than the above, distributions of income and gains earned from FIIs by foreign investors are generally subject to IRRF tax at a 15 per cent rate (except for investors located in tax havens, in which case the applicable rate is 20 per cent). If those gains arise from the sale of FII shares on a stock exchange, they may be tax exempt (provided certain conditions are met, including 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 the 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;

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(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 on real estate distinguishes 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 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. These restrictions include 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.

The 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 Defense Council is required for possession, ownership, rural lease or creation of any other security interest involving real properties located within the border zone. This 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).

IV 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 (landco). In

6 Law No. 5,709 of 1971 and Law No. 8,629 of 1993.
this structure, ownership of rural properties is held by the landco (the Brazilian company controlled by a local partner), whereas the opco is entrusted with operational activities (this company may be owned and controlled by the foreign investor). The landco 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.

V 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 Senate. Under the bill’s much more relaxed policy, acquisition of rural lands by Brazilian companies would be free of restrictions, regardless of the controlling shareholders involved (except in cases of control by foreign NGOs, foundations or sovereign funds). Notwithstanding that, the acquisition or lease of rural properties in the Amazon region or areas with legal reserve equivalent to 80 per cent would have to be approved by the National Defense Council not be allowed. The bill is yet to be discussed further and approved by the House of Representatives and the Senate, and then sanctioned by the Brazilian president. During this process, amendments could be made and the whole bill could change (as has already happened in similar cases). Considering the current political scenario in Brazil, there are real chances that the discussions regarding the approval of such bill takes place again in the near future.

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, SPVs, FIIs and FIPs. This requirement is difficult to implement when the foreign investment structure does not allow for identification of its beneficial owner.

In that regard, tax authorities have been issuing tax notices of late, which are yet subject to litigation, against fund administrators and custodian agents for their involvement in structures that should purportedly be viewed as non-compliant with the legal requirements mentioned above. In certain cases, tax authorities argued that if the final beneficial owners could not be duly disclosed to tax authorities, a 35 per cent WHT tax should apply on all distributions made by FIPs, for instance. Such allegation should not prevail following litigation in administrative and judicial courts, but a general recommendation is that investors provide detailed information on the ultimate beneficial owners of their respective investments.

iii Governance
The CVM is shortly to launch new rules lifting the bar on corporate government requirements for listed companies, and B3 has recently announced a package of adaptations and reforms to governance, compliance and disclosure rules applying to its most special trading segment, Novo Mercado.
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 5

CANADA

Brenda Gosselin and Stephen Pincus

I  OVERVIEW OF THE MARKET

i  The Canadian landscape

The Canadian real estate market delivered a healthy overall performance in 2018. While the first quarter of 2019 saw the overall investment in the Canadian real estate market fall 15 per cent from the previous quarter, and 20 per cent from the first quarter of 2018, the decade-long trend in producing superior total returns continues to be present. Since the global economic market crash of 2008-2009, Canadian real estate has experienced fairly significant price increases. This is in part attributable to Canada’s continued low interest-rate environment, as well as the capitalisation rate compression seen across all real estate classes and most urban geographies including Toronto, Vancouver and, more recently, Montreal.

The compression of industrial and multi-residential capitalisation rates have significantly affected Canada’s commercial real estate market. While the demand for property in the industrial sector remained high in 2018, supply constraints limited the transaction volume for this sector to C$1.7 billion in 2018.3 Year to date in 2019, investment in industrial real estate declined by 20 per cent as compared to the first quarter of 2018, and by nearly 40 per cent from the fourth quarter of 2018. The historic lows in office space vacancy rates seen nationally (2.7 per cent in the first quarter of 2019), and, more specifically, in Toronto (2.6 per cent at the end of March 2019), Vancouver (1.9 per cent in the first quarter of 2019) and Montreal (8.6 per cent, the lowest vacancy rate seen since the fourth quarter of 2013),4 have stimulated the development of office towers in these cities. Taken altogether, these conditions provided a stable environment for both lease and sale transactions in all areas of the real estate sector, as evidenced by AutoCanada Inc.’s sale of two parcels of real estate to Automotive Properties REIT for C$23.95 million and its subsequent entering into two 19-year, triple-net leases with Automotive Properties REIT, as well as Summit Industrial Income REIT’s acquisition of four properties in Edmonton, Calgary and Montreal in the first quarter of 2019 for C$130 million.

The low value of the Canadian dollar coupled with Canada’s reputation as a stable nation and attractive place to live has, in recent years, attracted significant foreign investment in Canadian real estate and put increased pressure on the demand for new housing due to the significant pace of the population growth of Canada’s major metropolises such as Toronto.

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1 Brenda Gosselin and Stephen Pincus are partners at Goodmans LLP. They wish to thank Nargis Fazli, student-at-law, for her assistance in the preparation of this chapter.
3 CIBC ‘2018 Canadian Real Estate Year in Review’.
In fact, the addition of over 77,000 persons in the City of Toronto for the 12 months ending July 2018 made it, in absolute numbers, the top growing city in all of North America and the second fastest growing urban region.\textsuperscript{5} This heightened demand for Canadian real estate has had a significant impact on residential properties in particular. The effect of foreign investment on the residential real estate market was most significantly experienced in Toronto and Vancouver, where residential real estate prices were accelerating at an unsustainable pace from 2015 through to 2017. It was only after the provincial governments of both cities intervened, by way of imposing a foreign buyers tax (and in Vancouver's case, a vacancy tax) and expanded rent-control rules, that a slight cooling of the markets, in the form of reduced sale volume and a tempering in the cost of a single family home, was seen. Perhaps unsurprisingly, following the implementation of those government interventions in Toronto and Vancouver, foreign investment in Montreal's real estate market surged 183 per cent in 2018 over the previous year.\textsuperscript{6} To date, foreign ownership of real estate has not been an issue in Alberta, Saskatchewan or Newfoundland. In fact, following the oil price downturn seen in 2015–2017, property valuations in the three provinces declined. While there has been some recovery of oil prices in 2018, prompting increased deal activity and a stabilisation of property prices, the occupancy levels observed across real estate sectors in these three provinces remain lower than those seen in the rest of Canada. In 2019, house prices are expected to continue to rise, albeit slowly. The national average price is expected to increase by 1.7 per cent year over year to C$496,800. Ontario, New Brunswick, and Quebec are expected to post the biggest annual rise in house prices at 3.3 per cent, 3 per cent, and 2.9 per cent respectively. In contrast, Saskatchewan, Newfoundland and Alberta are expected to see the biggest decline in year over year house prices by 3.5 per cent, 3.4 per cent and 2.5 per cent respectively. Actual sale activity is expected to increase 1.2 per cent in 2019, with rising interest rates and the B-20 mortgage stress-test offsetting the otherwise severe impact of continuing population growth. Year over year sales activity is expected to increase in New Brunswick, Quebec and Ontario by 3.2 per cent, 2.2 per cent and 1.4 per cent respectively. On the other hand, the year over year sales rates of Newfoundland, British Columbia and Nova Scotia are expected to decline by 7.1 per cent, 5.2 per cent and 4.3 per cent, respectively.\textsuperscript{7}

\section*{The investor}

Canadian domestic real estate investors can be broadly categorised as being one of three types: (1) institutional investors, consisting primarily of pension plans and life insurers, (2) public real estate entities, most significantly in the form of real estate investment trusts (REITS) with a smaller number of listed real estate operating corporations, and (3) private entities, such as family-owned businesses that develop or manage their own properties of varying scale and large scale Canadian private equity investors.

\begin{itemize}
  \item \textsuperscript{5} Clayton, Frank & Hong Yun (Eva) Shi. 'WOW! Toronto Was the Second Fastest Growing Metropolitan Area and the Top Growing City in All of the United States and Canada.' (31 May 2019) Ryerson Centre for Urban Research and Land Development.
  \item \textsuperscript{6} Sharma, Neil. ‘Canadian City Sees 183 per cent Surge in Foreign Buyer Investment.’ Mortgage Broker News (5 May 2019).
  \item \textsuperscript{7} Canadian Real Estate Association, 'Quarterly Forecast- Q1 2019' (14 June 2019).
\end{itemize}
Institutional investors

Those Canadian pension plans which invest in real estate are typically comprised of (1) large, recognisable public pensions, which make direct investments in both domestic and global real estate, (2) smaller public plans that rely on funds and external managers for their investments, and (3) private corporate pensions that partake in both direct and indirect investing. Over the past three decades, Canadian pension plans have commenced, and subsequently increased, their investments in real estate. As of October 2017, the top 24 Canadian pension funds owned C$188 billion in real estate, which amounted to an allocation of 13 per cent of their C$1.5 trillion assets in the real estate sector. The real estate allocation targets of Canadian pension funds was projected to increase anywhere from 1–3 per cent from 2017 to 2022, fueling speculation that the trend towards continued investment by these pension plans in real estate, including Canadian real estate, will continue at a steady pace.

These large Canadian pension funds have assets across all real estate classes, with prominent investment historically focused on Class A office space, premier urban shopping centres and office tower retail spaces in the major metropolitan areas of Canada, with some indirect engagement in development activities. A number of the large public pension plans that invest on behalf of various public sector employees significantly increased their allocation to real estate by privatising several of Canada’s largest real estate companies in 2000 and 2001. While these investments have become increasingly global in scope, the Canadian pension plans have continued to demonstrate a heavy inclination to invest in Canadian real estate. This may be in part due to the ability of pension plans to generally hold Canadian assets on a basis free from Canadian income tax under specific tax exemptions for Canadian registered pension plans or the favourable market conditions for promising returns in the Canadian real estate space.

Public real estate companies and REITs

Public real estate entities in Canada commonly exist in the form of a REIT. A REIT is a trust which, upon meeting the criteria outlined in Canada’s Income Tax Act (ITA), acts as a flow-through vehicle for Canadian income tax purposes. The first Canadian public REITs emerged in the 1990s as a solution to the collapse of Canada’s real estate market. In 1996, there were five publicly traded REITs on the Toronto Stock Exchange (TSX). As of June 2019, there are 39 TSX-listed REITs (of approximately 67 publicly listed real estate entities in Canada) with a total market capitalisation in excess of C$60 billion. Five of these REITs alone exceed a C$5 billion market capitalisation as of June 2019. While the Canadian REIT market remains small in comparison to its comparator market in the US, it is a continually evolving sector of the Canadian real estate landscape. In 2018, from January through to September, the S&P/TSX Capped REIT index recorded a total return of approximately 13 per cent. However, amid interest rate concerns, corrections in global equities and a sharp decline in prices, the S&P/TSX Capped REIT index fell to a total return of 6 per

8 Marr, Garry. ‘Canadian Pension Funds Have Amassed C$188B in Real Estate Assets. And They Are Hungry for More.’ Financial Post (5 October 2017).
9 ibid.
10 Specific examples include the privatisation of Oxford by OMERS; and Cadillac Fairview by Ontario Teachers’ Pension Plan.
12 Supra note 2.
cent through the last quarter of 2018. Both 2017 and 2018 saw very limited real estate IPO activity, however, in that same period, the equity and debt offerings made by existing REITs have continued to increase. For example, 2018 saw C$4.8 billion in equity offerings made by existing REITs, which is more than has been seen in the four years prior. 13 2019 is shaping up to be another active year in the Canadian market, from an equity issuance perspective, with C$1.5 billion in equity raised this year to date. 14

The majority of Canadian REITs are the product of smaller IPOs (typically under C$300 million) as compared to their US counterparts. Interestingly, this has had the effect of attracting a number of US-based cross-border REITs (also known as foreign asset income trusts), which are typically also REITs for Canadian income tax purposes. Canadian REITs own a full range of asset classes, such as office, retail, industrial and multi-residential. However, amongst the office investments, relatively few REITs own Class A office towers. REIT activity in the retail class is largely concentrated within regional and local shopping centers. Recently, investment in multi-use developments has increased amongst the greater capitalised REITs.

The management of a REIT can be internally conducted, through the trust's own employees, or externally conducted, by way of a manager under contract. A number of Canadian REITs are externally managed and do not have their own employees. In these situations, the terms of the management agreement between the REIT and the external manager can be an important consideration in structuring an M&A transaction. Any acquirer of the REIT will have to be prepared to either assume those functions (if the management agreement is to be terminated) or make arrangements with the manager to continue in some capacity after the transaction closes. The real estate market tends to favour internalised arrangements, while sponsors typically prefer the fees flowing to them from the external management arrangement.

Whereas REITs make up a significant portion of public real estate entities, there are comparatively fewer public real estate companies in Canada. This is in part attributable to the fact that public real estate corporations, in order to compete with REITS in terms of cost of capital, require large-scale and sufficient tax attributes to defer taxes over an extended period of time. Consequently, real estate corporations tend to partake more actively in the development of real estate, particularly in the residential class.

**Private entities**

Family-based private investors in real estate have significant industrial, retail and multi-residential holdings, but tend not to hold Class A offices or premium retail properties.

Canadian private equity funds (other than pension plans) which partake in real estate investing tend to focus their investments solely on real estate and, generally, do not invest across all economic sectors. Moreover, the equity raised by these private equity funds tends to be in the hundreds of millions, as opposed to the billions seen with public pension plans.

Large-scale Canadian private equity investors in real estate still remain fewer in number and tend to manage funds that have a significant pension plan backing. For example, in 2019 RBC Global Asset Management announced a partnership with pension fund manager British Columbia Investment Management Corp (BCI) and real estate developer QuadReal Property Group. The partnership has a portfolio of over 40 assets worth over C$7 billion.

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14 CI Financial Company 'First Asset Canadian REIT ETF Manager Commentary' (9 May 2019).
Historically, these pension backed private equity investors invested in real estate that requires active management or repositioning, or that are in the office asset class (although it continues to be rare for them to hold Class A offices) or in the commercial asset class. However, the increased development of condominiums seen across Canada in the last decade has largely been driven by private equity capital and pension funds.

II RECENT MARKET ACTIVITY

Activity in the real estate market driven by REITs, private equity firms and foreign investors has continued to be a characteristic of the Canadian market in 2018 and into 2019. Total transaction volume (for assets over C$40 million) remained strong in 2018 at C$16.3 billion in 2018, but was a departure from the record-breaking C$18.4 billion seen in 2017. Activity in the multifamily, industrial and office sectors dominated market activity in 2018 with the hotel sector continuing to see little activity with no assets over C$40 million being traded in 2018. Privatisations and acquisitions by REITs accounted for C$10.3 billion worth of transaction volume in 2018. In 2018, the S&P/TSX Capped REIT index delivered a 6 per cent total return over the year, thus falling below the long-term average of 9 per cent total return. Holding steady, the industrial sector was the strongest performing sub-sector in 2018, delivering an 18.0 per cent average total return, followed by the multifamily sector with an average total return of 16.5 per cent. During the first quarter of 2019, Canadian REITs on an unweighted basis across all asset classes were up 14 per cent year to date. The best performing asset classes of the first quarter 2019 was industrial, which saw a 21 per cent return, followed by retirement residences (at a 17 per cent return), and retail (at a 16 per cent return).

In the past five years, Canadian real estate entities have increased their focus on real estate development opportunities, as opposed to solely being engaged on acquisitions of existing properties. In 2018 and 2019 several large public REITs and pension funds, indirectly through their corporate real estate arms, began or completed the building of office towers or mixed-used projects throughout the downtown Toronto core. Cadillac Fairview, which is controlled by the Ontario Teachers’ Pension Plan (OTPP), kicked off construction of its expected C$1 billion downtown Toronto office tower in 2019. Allied Properties REIT and RioCan REIT announced in 2018 their plans to proceed with full development of ‘The Well’, a mixed-use residential, commercial and retail development located in Toronto. Beyond development of real estate, real estate entities continue to engage in meaningful acquisitions. Examples include the sale in 2016 by Oxford Properties Group (Oxford), a premier global real estate investment company, owned wholly by the Ontario Municipal Employees Retirement System (OMERS), of a 50 per cent interest of office properties in Toronto and Calgary to the Canada Pension Plan Investment Board (CPPIB) and Ivanhoé Cambridge’s sale of the Oakridge Centre shopping mall in Vancouver for C$961 million to QuadReal Property in 2017. In May 2019, Northview Apartment REIT announced a C$75 million equity offering, the net proceeds of which will be utilised, in part, to acquire a C$52 million property located in Guelph, Ontario. May 2019 also saw Allied Properties REIT acquire property in Toronto, Calgary and Vancouver for C$94 million. The acquisition of real estate by pension plans and real estate companies is not, however, limited to within

15 Supra note 2.
16 Supra note 2.
17 CIBC, ‘Canadian REITs Monthly’ (6 June 2019).
Canada’s border. An increasing number of Canadian real estate entities are pursuing global opportunities in real estate. In January 2018, the joint venture between CPPIB, Singapore’s GIC sovereign wealth fund, and student housing operator, The Scion Group, acquired a student housing portfolio comprising 24 assets across 20 university campus markets in the US. In May 2019, Invesque REIT announced it entered into an acquisition to obtain a portfolio of 20 seniors housing properties, located in Virginia, from Commonwealth Senior Living for C$340 million.

Foreign investment into Canadian real estate is not new. However, Asian-based, and in particular Chinese, investment into Canadian real estate surged from 2010 until 2017, when it began to experience a cooling off in response to, among other things, increased taxation. In 2018, increased regulation and taxation saw Asian investment in Vancouver fall from the C$1 billion-plus seen in 2016 and 2017 to almost C$350 million. In contrast, Toronto, which lacked the regulations Vancouver had put in place, took in C$526 million in Asian investment in 2018, up slightly from 2017.18 The manner in which the current political climate involving Chinese and Canada relations may impact on any foreign Asian-based investment in real estate has yet to be seen. An increased presence of US investors in Canadian real estate continued in 2018 with the C$3.8 billion acquisition of Pure Industrial Real Estate Trust (PIRET), a Canadian REIT, by Blackstone Property Brothers (Blackstone), one of the largest real estate private equity firms in the world based out of the US, and the acquisition of Milestone, a Canadian REIT with US assets, for C$1.7 billion by Starwood Capital, a US investment firm. While the first quarter of 2019 saw an increased interest from foreign capital sources in the retail asset class, in the multifamily asset class, foreign investment remained limited and foreign buyers remained mostly on the sidelines in the office asset class.

M&A transactions

Canada’s REIT market remains robust with over 39 publicly traded REITs with an aggregate market capitalisation in excess of C$60 billion, fuelling a significant portion of the M&A activity in the Canadian real estate space. 2018 was an active year in the real estate M&A market, with over C$16 billion in transaction volume (for assets over C$40 million).19

Early in 2018, an affiliate of Blackstone, together with Ivanhoé Cambridge as its acquisition consortium, acquired PIRET in an all-cash transaction. The transaction saw Blackstone acquire all outstanding units of PIRET for C$8.10 per unit, a 21 per cent premium over PIRET’s 20-day vwap. The total value of the transaction was C$3.6 billion and a capitalisation rate of 4.9 per cent.

Also early in 2018, Choice Properties REIT (Choice) launched the acquisition, by way of a plan of arrangement, of Canadian Real Estate Investment Trust (CREIT) in a cash and stock transaction comprised of approximately C$1.65 billion in cash and the issuance of approximately 183 million units of Choice, representing a 21 per cent premium over CREIT’s 20-day vwap, and implied a total of value of C$6 billion and a cap rate of 5.5 per cent. The successful completion of the acquisition saw the enterprise value of Choice reach approximately C$16 billion. REIT-to-REIT mergers like this are relatively rare in the Canadian REIT market.

19 Supra note 2.
Brookfield Property Partners also sold a 50 per cent interest in its two new Toronto towers to a foreign domiciled buyer Dadco Investments (reportedly related to Victor Dahdaleh) in March 2018 for C$850 million.

In the fall of 2018, Agellan Commercial Real Estate Investment Trust (Agellan) entered into an arrangement agreement with Elad Genesis Limited Partnership (El-Ad), an affiliate of El-Ad Group Ltd. The all-cash transaction saw El-Ad acquire all of Agellan’s units for C$14.25 per unit, thus valuing Agellan at C$676 million. The transaction represented a 10 per cent premium over the 20-day vwap and a capitalisation rate of 7.4 per cent.

The end of 2018 gave witness to Oxford beating out its bidding war competitor, Blackstone, to close its C$3.4 billion privatisation acquisition of the Investa Office Fund. The deal saw Oxford raise its bid to C$5.50 a share, just enough to top Blackstone’s last offer of C$5.4 per share. Investa Office shares traded at C$5.4 before the announcement.

The real estate M&A market in 2019 started strong with NWH Australia AssetCo Pty Ltd., as trustee for a controlled entity of NorthWest Healthcare Properties Real Estate Investment Trust, announcing the completion of an arrangement agreement to acquire 11 freehold hospital property assets from ASX-listed Healthscope Limited and its affiliates for approximately C$1.2 billion as part of a sale and leaseback transaction.

2019 has also been privy to ongoing disposition activity in its first quarter. In February, RioCan REIT disposed of a retail shopping center in suburban Victoria, BC, which was purchased by Crestpoint Real Estate Investments and Anthem Properties in a deal worth C$110 million. A few months later in May 2019, H&R REIT announced it had entered into an agreement to sell The Atrium, a 1.1 million square feet office and retail complex occupying a full city block in one of downtown Toronto’s busiest intersections, for C$640 million. This represents a C$40 million gain relative to its fair value (as calculated using IFRS 13 standards). Also in May 2019, Plaza Retail REIT announced it had completed the sale of eight properties, totalling 19,309 square feet and located in Winnipeg, London, Ottawa and Halifax, for C$9.9 million.

ii Capital markets activity – public offerings

The Canadian REIT IPO market was relatively tame in 2018, however, two new REITs were introduced through initial listings on the TSX: Minto Apartment REIT and BSR REIT.

Minto Apartment REIT completed its initial public offering in July 2018 raising gross proceeds of C$230 million (including the full exercise of the underwriters’ over-allotment option), comprised of an issuance of 15,863 trust units at a price of C$14.50 per unit. In connection with the offering, Minto Apartment REIT indirectly acquired a portfolio of 22 high-quality income-producing multi-residential rental properties, with 4,279 suites, from Minto Properties Inc., one of The Minto Group of companies. The net proceeds of the offering were used by the REIT to fund the indirect acquisition of the properties and reduce Minto Properties’ retained interest. Following completion of the offering (including the exercise of the over-allotment), Minto Properties Inc. indirectly held a retained interest of approximately 56 per cent of the REIT.

BSR REIT completed its initial public offering in May 2018, issuing an aggregate of 13.5 million trust units at a price of C$10 per unit, raising gross proceeds of C$135 million. In connection with the offering, the REIT indirectly acquired a 48-property portfolio held indirectly by BSR Trust, LLC. The portfolio consisted of multifamily residential properties
located across five bordering states in the Sunbelt region of the US. The net proceeds of the offering were used by the REIT to repay approximately C$122.3 million of indebtedness owing by BSR.

In March of 2019, NexPoint Hospitality Trust announced it had completed its initial public offering of 917,700 trust units at a price of C$5.00 per unit. The offering raised gross proceeds of C$4,588,500. NexPoint was created to acquire an initial portfolio of 11 hospitality assets located in the US and to raise capital to acquire hospitality assets in the US.

The first quarter of 2019 also saw significant public offering activity. In January, SmartCentres REIT announced it had closed its equity offering of 7.36 million voting units at a price of C$31.25 per unit for gross proceeds of C$230 million. The net proceeds from this offering were used to repay amounts drawn on credit facilities and to fund development programs in the Vaughan Metropolitan Centre, seniors housing, multifamily residential, retail and other initiatives. In April, Granite REIT closed its public offering of 3.749 million units at a price of C$61.50 per unit, for total gross proceeds of approximately C$230 million. The net proceeds from this offering were earmarked to partially fund the potential acquisition of two properties, one industrial income producing property in Ohio and one development property in Calgary, Alberta, as well as to fund development costs associated with future build-to-suit opportunities on a parcel of land in Indiana.

iii Investor activism

As previously noted, most publicly listed real estate entities in Canada exist in the form of a REIT. Most REITs, because they are trusts, do not provide to their unitholders those same rights and remedies as would be typically available to a corporate shareholder. However, the inability of unitholders to access such things as the oppression remedy, dissent rights and rights to call meetings or make proposals, have not gone unnoticed. Institutional governance groups have and continue to pressure REITs to adopt more uniform trust declarations, with rights comparable to those of a corporate shareholder. In light of this mounting pressure, an increasing number of REITs are adopting some of those rights.

Canadian corporate law allows shareholders with a 5 per cent stake in a company to call for a special meeting, compared to the 10 per cent required under US law. Furthermore, in Canada, a shareholder can solicit votes from 15 other investors without issuing a proxy circular under what is referred to as the ‘quiet solicitation’ exemption under the applicable rules. This allows a relatively small shareholder to gather powerful allies behind closed doors. Taken together, these circumstances give activists a more accessible basis from which to launch their campaigns. Canada’s friendliness to shareholder activism helps explain why activism within the real estate market has been undergoing a paradigm shift in recent years.

Historically, the REIT market has seen a limited amount of unitholder activism, and driven largely by private equity where it has occurred. Over the last decade, there have been just under a dozen publicised instances of REIT unitholder activism. In 2014, Orange Capital Partners, together with Kingsett Capital (an existing unitholder of InnVest REIT), called a successful meeting of unitholders to expand and reconstitute the board of InnVest REIT with seven new independent trustees, all of whom were nominated by Orange Capital. Two years following the InnVest board reformation, InnVest REIT was sold at a 37 per cent premium to market.

With activism continuing its ramp-up in the Canadian marketplace, in 2017 alone, there were a number of prominent public unitholder activist campaigns launched against REIT management. Activist investors FrontFour Capital Group and Sandpiper Group, owners of
approximately 6.2 per cent of the outstanding units of Granite REIT, called for a meeting of unitholders to replace the board. Ultimately, through activist efforts, the investor activist groups were able to not only to place three representatives on the board of Granite REIT, but also to remove the Chairman and Vice-Chairman of the board. Following significant public pressure from investors and in an effort to avoid a costly proxy contest, Agellan reached a settlement agreement with Sandpiper Group and ELAD Canada Inc., which involved board membership changes and the internalisation of management functions.

Another form of activism utilised in 2017 involved institutional investors joining forces to demand higher prices in takeover bid transactions. This is what transpired when unitholders of Milestone Apartments REIT demanded an increased premium from Starwood Capital Group, which had launched a takeover bid for Milestone Apartments REIT, and was eventually given an attractive 16 per cent premium over market. Early in 2019, Sandpiper Group announced it was set to overhaul five more Canadian real estate entities in the calendar year. While Sandpiper Group did not announce the names, or even identify the type of real estate entities it intends to pursue, it did make clear it was prepared to bridge the value gap created by underperforming REITs and further highlighted the expected level of activist activity REITs may face in the coming year.

REITs are vulnerable to activists in part because they are not governed by corporate statutes, but rather by their own declaration of trusts. Consequently, in response to increased shareholder activism in recent years, a large number of REITs have adopted an array of important corporate governance enhancements.

### III M&A TRANSACTIONS

#### i Legal framework and deal structures

There are numerous methods by which a public Canadian company can be acquired. With respect to M&A transactions in the real estate market, the two most commonly seen are structured either as a plan of arrangement or a takeover bid. An overview of these transaction structures, which are not unique to the public real estate M&A, is provided below.

**Plan of arrangement**

A statutory plan of arrangement is a voting transaction that can be effected by a Canadian corporation according to the laws of the jurisdiction in which the company was incorporated. A plan of arrangement is unique in that it can permit a buyer to acquire 100 per cent of the shares of a target company, without having to require a buyer to make an offer, or enter into a share purchase agreement, with each and every shareholder of the target company. Instead, the purchaser is required to enter into an arrangement agreement with the target company and when the plan of arrangement is completed, the purchaser acquires all of the outstanding securities of the target company in a single step. As such, it is unsurprising that a plan of arrangement is frequently utilised in friendly, non-hostile acquisitions.

The arrangement agreement is first negotiated with a target company’s board of directors. Once the board of directors approves it, the target will apply to a court to begin the process of approving and effecting the arrangement. The initial appearance before a court will

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be to secure an interim order, which sets the procedural rules for the arrangement, including the manner in which the meeting of securityholders will be called and held, setting out those classes of securityholders that are entitled to vote and the requisite levels required to approve the arrangement. The interim order is usually uncontested.

Once an interim order is provided, the plan of arrangement is presented to the target company’s shareholders for their approval. The details of the transaction, including the specific steps contemplated by the plan of arrangement, are set forth for shareholders in an information circular, the content and form of which is governed by applicable securities laws. Although the requisite shareholder approval threshold is determinable by a court under an interim order, acquirers typically propose that they be obliged to 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 transaction were effected outside the arrangement process. In most Canadian jurisdictions, the relevant corporate law statutes set out a threshold of two-thirds of the votes cast at the meeting of the target company's security holders. Convertible securities, such as warrants and convertible debentures, are typically not given the right to vote in a plan of arrangement, unless the rights of these security holders are being altered by the arrangement in a manner that is unfair or is unreasonable.

If the requisite majority of shareholder approval is obtained, then the arrangement is presented to the court for its final approval. Disaffected stakeholders can, at this time, appear before the court to challenge the arrangement, although, practically speaking, the vast majority of arrangements are presented to a court without opposition. The court, in reviewing the plan of arrangement, is guided by considerations of fairness and reasonableness, with respect to the effect of the transaction on shareholders. If the plan of arrangement is approved by the court, it then becomes binding on all shareholders of the target company.

Given that plans of arrangement are voting transactions effecting corporations, the REIT-to-REIT M&A context necessitates the presence of a corporation somewhere in the REIT structure. To date, courts have been accommodating in the flexible use of the plan of arrangement structure, even where the transaction is primarily a REIT-to-REIT M&A transaction. Moreover, a unique feature of REIT-to-REIT mergers is that to achieve a tax deferral, if offering REIT units for consideration, the steps outlined in Section 132.2 of the ITA must be adhered to, and within those steps is the requirement for a plan of arrangement.

Takeover bid

A takeover bid, the substantive equivalent of a tender offer under US securities laws, is a transaction in which a purchaser makes an offer for the securities of a target company directly to the target company’s securities 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.

Each Canadian province and territory has adopted a uniform regime under which takeover bids are regulated. The relevant legislation requires that a takeover bid be made to all registered holders of the class of voting or equity securities being purchased, and that the offer be sent to all registered holders of securities convertible into or exercisable for such voting or equity securities. Additionally, the offeror must make the same purchase offer to each securities holder in the class.

The takeover bid circular, delivered to all requisite securityholders, must contain prescribed information about the offer, the offeror and the target company. Where the consideration offered in exchange for the solicited securities consists, in whole or in part,
of the securities of the offeror, the disclosure document must also include prospectus-level disclosure about the offeror. While the uniform regime adopted by the securities regulators in Canada sets out the minimum standards relating to the conduct of the bid, including disclosure requirements, it is generally unnecessary for an offeror to present the contents of its disclosure documents to securities regulators, nor is it likely that the takeover bid circular, unless a complaint is made, will be reviewed by the regulators once filed.

Once a takeover commences, the board of directors of the target company, or the trustees of the target REIT, have a duty to consider the offer and an obligation to make a recommendation to security holders regarding the adequacy of the offer. However, the ultimate determination as to whether to accept or reject a takeover bid is made by the security holders.

The determination as to whether a triggering event for a takeover bid has occurred is based on objective factors. The most important factors, however, are the percentage of voting or equity securities beneficially owned or controlled by the offeror (and any of its joint actors) and the number of additional securities subject to the takeover bid. The threshold for triggering a takeover bid is 20 per cent of any class of voting or equity securities. When determining whether the threshold for triggering a takeover bid will be met, the number of securities beneficially owned by the offeror is interpreted to include both those securities which the offeror has a right or obligation, through options, warrants or convertible securities, to acquire within 60 days, as well as, any securities held by affiliates or joint actors in the takeover bid.

Effective 9 May 2016, changes were made to the Canadian takeover bid regime. Under this new regime, all non-exempt takeover bids (including partial bids) are subject to the following requirements:

a. 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 extended for at least an additional 10-day period (the 10-Day Extension Requirement); and

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

These updated provisions, by increasing the amount of time afforded to a target company to respond to a takeover bid, has important implications for strategic shareholder rights plans and will likely continue to influence how M&A activity is structured.

Takeover bids are infrequently utilised for friendly transactions in Canada. Among REIT-to-REIT transactions, they are even rarer. This is because most REIT-to-REIT transactions involve equity considerations, and cannot be tax-deferred consolidation transactions unless they conform to Section 132.2 of the ITA which requires the transaction to occur by way of plan of arrangement. As a result, nearly all REIT-to-REIT transactions occur by way of a plan of arrangement. Even the rare M&A deal which starts hostile generally ends up becoming a negotiated plan of arrangement transaction, albeit for an increased price.
ii Acquisition agreement terms

The overwhelming majority of real estate transactions and deals take place by way of a plan of arrangement. The significant difference observed in the context of real estate mergers is that the specific mechanics of the plan of arrangement must conform with the directions of Section 132.2 of the ITA to ensure a tax-deferred rollover for a trust unit offered in consideration by an acquirer REIT. Conditions in public real estate mergers are typically similar to any public merger transaction.

One common deal protection, typical to most public merger transactions, is a non-solicitation (‘no shop’) provision. By adopting this provision, a target company not only obliges to recommend the transaction to its securities holders, but also agrees not to solicit nor negotiate other acquisition offers and to pay a break fee if the agreement is terminated in certain circumstances. In accordance with the exercise of its fiduciary duties, however, a board of directors is permitted, despite the existence of a non-solicitation provision, to change its recommendation, engage with a rival bidder that makes an unsolicited acquisition proposal that is likely to result in a superior offering, or enter into an agreement that supports a superior offering. The determination as to what constitutes a superior offering is a matter of negotiation; although it is almost invariably defined according, at least in part, to whether the proposal is more favourable from a financial perspective to securities holders, than is the existing transaction. Break fees are permissible in Canada, provided that they permit a reasonable balance between their negative effect as an auction inhibitor and their potential positive effect as an auction stimulator (including if the fee was necessary to induce a bid). Reasonable break fees are typically understood to range from 1 per cent to 5 per cent of deal equity value.

When a target board of directors seeks to defend a company from a takeover bid, a number of defensive tactics are available. The most common is the use of a poison pill or shareholders rights plan. However, as discussed above, under the new legislation these types of plans will be void after 105 days. Additional defensive tactics include issuances of securities to dilute the bidder or potential bidder (often by placing the securities in friendly hands), the sale of assets, recapitalisations, the acquisition of a white knight and asset lock-ups.

iii Financing considerations

Considerations and conditions in public real estate transactions are typically similar to other public merger transactions. One distinct difference often found in real estate transactions, that would not be found in non-real estate transactions, is the potential presence of a condition addressing the necessary percentage level of mortgagee consents to the assumption of mortgages.

To finance their real estate merger transactions, private equity acquirers will often draw from the equity commitments of their limited partnerships. Pension funds, on the other hand, often finance the equity portion of their real estate transactions by drawing on their vast reserves of liquid securities and assuming underlying mortgages. For the most part, mortgagors tend to consent to the assumption of their mortgages, particularly where the acquirer is well regarded as a significant player in the real estate market. Where mortgages have a provision requiring repurchase upon a change of control, which is common, credit lines or fresh mortgage alternatives must be available to the acquirers.

The nature of the Canadian bought deal underwriting structure, in which underwriters agree to purchase all of the offered securities under a prospectus, offers certainty of funding to a public REIT acquirer. As a result, a publicly traded REIT acquirer will often arrange a
bought deal financing concurrently with the announcement of their acquisition transactions. Because bought deals can be through a subscription receipt structure, the acquirer’s financing becomes contingent on the closing of the corresponding acquisition.

Public REIT-to-REIT merger transactions are typically in the form of unit-for-unit deals, with an assumption of the underlying mortgages of the target REIT. The equity portion of such a transaction can be sourced by way of available liquid funds, or can be financed through a bank facility, which would be subsequently repaid through a public debenture or the issuance of equity.

iv Directors’ duties
Canadian corporate statutes impose two duties on directors: a duty of care and a duty of loyalty.

The Canada Business Corporations Act (CBCA) requires every director of a corporation, in exercising their powers and discharging their duties, to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The applicable standard utilised by courts to determine whether a director has satisfied their duty of care is both objective and subjective in nature. Objectivity is used to determine how a reasonably prudent person ought to have acted, however, the circumstances surrounding the exercise of a director’s duties modify the objectively reasonable person standard to account for the specific facts of the situation, as well as the subjective knowledge and experience of the particular director.

The duty of care imposed upon directors does not rise to the level of perfection. Rather, courts have generally deferred to the business decisions of directors where they have been satisfied that the directors exercised an appropriate degree of prudence and diligence. This deferential approach to directors decisions has become known as the business judgement rule (BJR). The BJR is a legal presumption that insulates directors from legal liability, so long as they act in an informed, prudent and diligent matter. In instances where the BJR is challenged, the onus is on the claimant to show that the directors’ decision is fraudulent, illegal, or represented a conflict of interest. Some of the factors courts have considered to determine whether a director’s decision should be reviewed are whether: an independent committee was used, an outside valuation was obtained, professional advice was sought, the decision was made over a sufficient amount of time, alternatives were considered, the transaction was negotiated, and proper documentation was prepared. The theme behind these factors is that they reflect the court’s tendency to focus on the processes behind, rather than the outcome of, directors decisions. The courts have maintained that the judiciary should not seek to substitute its judgment for that of a board of directors, unless the circumstances surrounding a decision are so unusual and extreme to warrant such intervention. Consequently, if a director can demonstrate that their business decision was reasonable, in light of all the circumstances about which they knew or ought to have known, it is unlikely a court will have found them to have breached their duty of care. In fact, a director’s failure to meet their duty of care often arises in situations where the director shows passivity to, and inattention towards, the business’ activities.

The statutory duty of loyalty requires directors to ‘act honestly, in good faith, and with a view to the best interests of the corporation’. A director’s duty of loyalty is owed exclusively to the corporation, as a whole, rather than any individual group of stakeholders. In fact, the Supreme Court of Canada has held that directors, in determining what is in the best interests of a corporation, may look to the interests of, among others, shareholders,
employees, creditors, consumers, and governments. While this approach encourages directors to consider the effect of their decisions on different groups of stakeholders within a corporation, it continues to remain the case that the interests of equity security holders are given significant weight. Accordingly, the determination of whether an acquisition proposal delivers the best value reasonably available to equity security holders remains a central focus in director deliberations.

Directors cannot contract out of their duties and can be held personally liable for a breach of their duties. Although REITs are trusts, and therefore not governed by the CBCA or its provincial equivalents, it is the case that the common law applies a similar, if not higher, standard of care and loyalty to the REIT trustees as it does to corporate directors. Moreover, REITs, in their trust instruments, have generally adopted similar standards of care and loyalty to those in Canada’s corporate legislation. Furthermore, although no definitive decision on the matter has been made, Canadian courts have typically held trustees of public REITs to the standards expected of the directors of public companies.

v Tax considerations
Taxation in Canada is governed primarily by the ITA, a federal statute, as well as by sales tax, corporate tax, and provincial and territorial tax laws. The ITA imposes an annual income tax on the taxable worldwide income of: every ‘person’ resident in Canada (including corporations); those non-resident persons who carry on business in Canada; and any disposition of taxable Canadian property.

As of March 2019, the basic Canadian combined federal and provincial tax rate for income earned by a corporation ranged from as low as 26.5 per cent (Northwest Territories, Ontario and Quebec) to as high as 31 per cent (Prince Edward Island and Nova Scotia).

Non-residents of Canada may be subject to the ITA either by way of carrying on business in Canada or by disposing of taxable Canadian property. Consequently, the tax treatment of any investment made by a non-resident in Canadian real estate will depend on whether the investment is made directly by the investor or through a Canadian entity (i.e., a corporation). Ultimately, the determination as to whether an activity constitutes carrying on a business is a question of fact, determinable on the basis of the facts and circumstances. Even where it is not found that a business is being carried on, it may be the case that a withholding tax to non-residents is applied to the passive income gained.

What qualifies as taxable Canadian property, for the purposes of determining whether a tax on the disposition of that property should be applied, is determined according to the ITA and does not depend on the seller being resident in Canada. As such, non-residents may be subject to income tax in Canada through this channel.

Under the ITA, Canadian corporations that seek to make certain types of payments to non-residents, are required to withhold tax at a rate of 25 per cent. The types of payments which trigger a withholding tax include interest paid to non-arm’s length parties, participating interest, certain administration/management fees, rents, royalties and dividends. Treaties can serve to provide extensive relief for dividends, reducing the withholding tax to 15 per cent or 5 per cent in situations where the non-resident recipient holds over 10 per cent of the voting shares of the issuing corporations. Most interest payments payable under a traditional loan held by a non-resident arm’s length lender are also exempt from withholding tax. However, loans between non-arm’s length parties are subject to withholding tax under the ITA. Where treaties are in place, however, the rate of tax withheld on the non-arm’s length loan interest is, in most treaty jurisdictions, reduced to between 10 per cent and 15 per cent.
As previously discussed, REITs are designed to act as ‘flow-through entities’. This means that, upon meeting the ITA qualifications to be recognized as a REIT, a REIT will be exempt from paying Canadian income tax, so long as it distributes its annual taxable income to its unitholders. Where it happens that the unitholders of a REIT are non-residents, the REIT is required, upon distributing its income, to withhold tax at a 25 per cent rate (unless there is an applicable tax treaty). Generally, the gain realised upon the disposition of REIT units is not subject to Canadian tax consideration so long as the unitholder and those persons dealing with the unitholder hold less than 25 per cent of the units of the REIT.

Other tax considerations also need to be considered in circumstances where a non-resident investor in Canadian real estate earns passive income from their property (for example, rental income). Further Canadian real estate, and shares of corporations that largely derive their value from Canadian real estate are taxable under the ITA, with limited exceptions. Factors such as how the real estate is held and whether it was held for resale or trade purposes or otherwise will have a significant impact on the tax implications associated with any disposition of property.

In Canada, the transfer of real estate can have significant tax implications. For example, the disposition of real estate in Ontario can trigger the application of land transfer taxes, municipal taxes, foreign buyer taxes, and value added taxes. A land transfer tax is a form of provincial tax payable by the purchaser of real property, upon the closing of the transaction. Subject to certain exemptions, land transfer tax is payable on every registered conveyance of land tendered and every unregistered disposition of a beneficial interest in land. The rate of land transfer tax is not fixed, but rather stratified, and is determined according to the type of property being transferred and the total value of consideration paid. However, in certain circumstances, general anti-avoidance regimes put into place in the Land Transfer Tax Act ensure that the land transfer tax is payable on the fair market value of the real property, rather than on the total value of the consideration paid. The exemptions for the application of the land transfer tax include, but are not limited to, certain transfers between: spouses, an individual and their family business corporation, and family members whose farmed land is being conveyed.

In Ontario, municipalities are entitled to levy annual property taxes under the Municipality Act. In exchange for these taxes, municipal governments provide many city-based services. The calculation of municipal tax is dependent on the value of the property compounded by the ‘mill rate’, which is determined annually and based on the financial needs of the municipality. In the last decade, some municipalities, such as Toronto and Montreal, have introduced a municipal land transfer surtax. This municipal land transfer tax is paid, by the purchaser of real property, in addition to provincial land transfer taxes.

Following the rapid, unsustainable rise of residential housing and rent, Ontario and British Columbia introduced a foreign buyer land transfer tax. This surtax is paid by foreign, non-resident purchasers of Canadian property when the transaction closes. British Columbia’s 20 per cent foreign buyer land transfer tax is applied only to those properties purchased in the Metro-Vancouver area. Vancouver has also instituted an empty homes tax of 1 per cent annually and was introduced to return empty or under-used properties to the rental market in Vancouver. In Ontario, the 15 per cent ‘non-resident speculation tax’ only applies to property purchased by non-residents in the Greater Golden Horseshoe Area, Toronto.
The federal government imposes a value-added tax, known as the Goods and Services Tax (GST), at a rate of 5 per cent, on goods and services purchased in Canada. With limited exceptions, everyone is required to pay GST on purchases of taxable goods and services, including for real estate.

Where the seller of goods or services is a non-resident of Canada, the method by which they remit GST to the federal government varies. Non-residents of Canada who carry on business in Canada, and make taxable supplies in the course of that business, are required to register under Canadian GST legislation to collect and remit GST. Moreover, if these non-resident registrants do not have a permanent establishment in Canada, then they must, to meet collection and remittance obligations, post security with the Canada Revenue Agency. If a non-resident registrant does have a permanent Canadian establishment, then it can simply register for and collect GST on taxable goods and services. If a seller is a non-resident, is not a GST registrant, and is not carrying on a business in Canada, then the purchaser of the goods or services may be required to self-assess the GST payable on the transaction.

In Ontario, the federal GST is harmonised with the provincial sales tax and collected as a single tax known as Harmonised Sale Tax (HST). In 2019, Ontario charged HST at a rate of 13 per cent (which includes the 5 per cent GST). Generally, the application of HST mirrors that of GST. In those provinces and territories where HST is not applied, provincial sales tax is not applied to the purchase of real estate.

Investment in real estate in Canada (whether directly or indirectly, by a Canadian resident or non-resident) will have significant tax implications which vary depending on the individual or specific circumstances relevant to the particular situation. Investors (and real estate entities) are advised to seek independent tax advice in connection with any potential investments or dispositions.

vi Regulatory considerations

Foreign ownership

Property ownership falls under provincial, rather than federal, jurisdiction in Canada. Newfoundland, Nova Scotia and New Brunswick are the only remaining provinces in which there are no restrictions on foreign ownership of land.

Manitoba, Saskatchewan, Alberta and Quebec have legislation restricting foreign ownership of parcels of farm land. Manitoba restricts foreign ownership of farmland to 40 acres. Saskatchewan restricts the purchase of farmland by non-residents to 10 acres. Alberta legislation caps foreign ownership of agricultural land at two parcels containing 20 acres, however, the legislation does not apply to certain commercial uses of land. Quebec’s legislation, the most restrictive of the bunch, prohibits non-Quebec residents from acquiring more than four adjacent hectares of farmland (roughly 10 acres). Prince Edward Island (PEI) restricts non-PEI residents (defined as persons who have not lived in PEI for at least 365 days over 24 months) from purchasing more than five acres of land, or 165 feet of shoreline. In 2016, British Columbia implemented an additional property transfer tax of 15 per cent on Metro Vancouver homes purchased by foreign buyers. When this foreign buyers’ tax was initially introduced, however, there were concerns that it was too sweeping, penalising those recruited to Vancouver on work permits. As a result, the tax was amended in 2017. Since then, it has also been raised to 20 per cent. In 2017, Ontario, following in the footsteps of British Columbia, introduced a 15 per cent non-resident speculation tax on residential property purchased in the Greater Golden Horseshoe Area by anyone who is neither a citizen nor permanent resident of Canada.
**Competition Act**

Under the Competition Act, mergers and acquisitions of all sizes and in all sectors of the economy are subject to review by the Commissioner of Competition. The Competition Act requires companies to notify the Commissioner of Competition, by way of a pre-acquisition filing, if a proposed transaction meets, or exceeds, certain asset size or revenue criteria. Generally, a pre-acquisition filing must be submitted if:

a. either the value of the assets to be acquired, or the value of the assets owned by the corporation being acquired, or the annual gross revenue of the business being acquired exceeds C$96 million (in 2019); and

b. the parties to the transaction, together with their affiliates, have either assets in Canada, or annual gross revenues from sales in, from or into Canada, exceeding C$400 million (in 2019).

Upon receipt of the filing, the Commissioner of Competition has 30 days, although extensions are common, to review the filing so as to narrow and refine issues and to determine what, if any, additional information is required from the parties to assess anti-competition concerns. In particular, the Commissioner will consider what additional information is required to determine whether the proposed transaction is likely to lessen or prevent competition substantially. Real estate, historically, has not been a sector in which the Commissioner has given refusals or divestiture orders.

**Investment Canada Act**

Under the Investment Canada Act (ICA), certain acquisitions by non-Canadians of Canadian businesses are subject to pre-closing review. The application of the ICA is limited to those investments made by non-Canadians that involve an acquisition of control over a Canadian business. Whether a pre-closing filing for a control transaction will need to be submitted to the Minister of Industry will depend on:

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

b. the book value of the Canadian business (if the acquirer is a state-owned enterprise, or is not a world trade organisation state member); and

c. whether the business is in a sensitive sector. 21

For acquirers who are not a state-owned entity, the financial threshold that triggers the requirement for a pre-closing review under the ICA depends on the nationality of the investor. Nationals of a specified free trade party 22 that directly acquire control of a Canadian business are only subject to a pre-closing review under the ICA if the enterprise value 23 of the Canadian business exceeds C$1.568 billion (in 2019). Investors who hail from World Trade Organisation member state are subject to a pre-closing review under the ICA if the enterprise value of the Canadian business exceeds C$1.045 billion (in 2019).

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21 Real estate is not a sensitive sector under the Investment Canada Act.

22 The European Union, the United States, Mexico, Chile, Colombia, Honduras, Panama, Peru, South Korea, Japan, Vietnam, Singapore, Australia or New Zealand.

23 The enterprise value of a business is calculated differently.
For acquirers who are state-owned entities, the book value threshold required to trigger a pre-closing review will depend on the nationality of the state-owned entity. State-owned entities from WTO nations are only required to file a pre-closing review under the ITA if the book value of the Canadian business they are acquiring meets or exceeds C$416 million (in 2019). Non-WTO state-entities directly purchasing Canadian businesses are required to submit a pre-closing review if the book value of the Canadian business exceeds 5 million dollars. An indirect control transaction by a non-WTO state-entity for a Canadian business will require a pre-closing review only if the book value of the business exceeds C$50 million (in 2019).

In those transactions where a non-Canadian investor gains control of a Canadian business that does not meet nor exceed the financial threshold required to trigger the submission of a pre-closing filing, a notice of investment must be filed, within 30 days of closing.

The ICA reserves a residual right to review any non-resident acquisition of a Canadian business on nation security grounds. This right of review is unique in that it is not conditional on value or quality thresholds being met. As such, even investments which do not involve high asset values, or an acquisition of control over the business may be subject to review on national security grounds.

The ICA defines a Canadian business to mean a business carried on in Canada that has: (1) a place of business in Canada, (2) an individual, or individuals, in Canada who are employed, or self-employed in connection with the business, and (3) assets in Canada used in carrying on the business. Whether Canadian real estate assets can be considered a Canadian business for this purpose is a question of fact, determined primarily by the second criterion – specifically, whether there are individuals employed in connection with the real estate. Consequently, a hotel that has employed staff in Canada to render their services would be considered to be carrying on a business, whereas an office tower that has outsourced all of its services would not.

IV OUTLOOK

The year of 2018 was marked by uncertainty, as evidenced by the number of largely unanticipated macroeconomic and geopolitical developments. For example, the end of the North American Free Trade Agreement (NAFTA) has shaken up global trading patterns and affected commodity prices, which can have the effect of raising the costs of real estate development in Canada and putting further pressure on affordability. One real estate trend that emerged in 2018 and the first part of 2019 was the increased diversification of assets. For example, developers and investors are entering partnerships and joint ventures to reduce risk by making the most of a partner’s skills and resources.24 Moreover, it seems that real estate entities are starting to redirect additional development funds to the US, where taxes are lower, regulations are fewer and markets are larger.25 Looking forward to the last six months of 2019, the markets continue to face a highly uncertain economic environment. This is attributable to a range of concerns, including fast-paced technological growth, the potential for interest rate hikes, rising household debt levels, and fears over the pace of global growth. Any of these developments could have a significant impact on the Canadian real estate sector. Despite

25 ibid.
these uncertainties, the investment demand for Canadian commercial real estate continues to be strong across Canada. Investor confidence in industrial and office assets is expected to remain high amid land shortages and high occupancy rates. Similarly, with continued developments in lifestyle trends, retail assets are presenting themselves as capable of creating new opportunities due to their prime location. Finally, the ongoing housing affordability saga seen in major metropolitan cities, coupled with the ongoing population growth, is likely to encourage investors to continue to chase opportunities within those markets.
I  INTRODUCTION

Real estate investment trusts (REITs), 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, owing to legal obstacles, REITs have not been well developed in China. This chapter will provide an overview of the legal framework of REITs in China and analyse the obstacles in the markets and REITs trends in China from the perspective of a legal practitioner. The aim is to illustrate the need for REITs in China and the methods that must be employed to overcome the legal and market restrictions.

II  ORIGINS AND DEVELOPMENT OF REITS IN CHINA

REITs are a type of trust plan in which funds from specific investors are collected through 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 (e.g., sales and lease of properties in the form of dividends proportionately). Within the context of Chinese law, the terms trust and fund have specific legal definitions. REITs do not necessarily have to adopt the forms of trust or fund. Rather, a wide range of legal vehicles can be adopted (e.g., corporation, collective trust, contractual fund, etc.).

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 the incomes, reduce the financial risk as the consequence of mortgages provided by the bank and ensure the sustainable development of the real estate industry. Considering the advantages of REITs, the Chinese government has been attempting to establish the necessary regulatory and operational framework for REITs, which includes the adoption of several pilot projects. The innovative nature of REITs was discussed particularly during the period of economic structural reform that focused on the control of the real estate

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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.\(^3\) With the significant decrease and the subsequent increase of real property prices in 2008, the State Council, the People’s Bank of China (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, 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.\(^5\)

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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 that 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 that 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 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 that have good qualifications and...
STRUCTURE AND ROLE OF PUBLICLY TRADED REITS AND REOCS

The success of REITs in developed countries and regions such as the US, Australia, Japan, Singapore and Hong Kong illustrates the relationship between the characteristics of REITs products and the development of the local economy. In these countries and regions, REITs have played an important role in the sustainable development of a real estate industry.

Currently, the financing methods available to 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 are greatly affected, and so is the cash flow of real estate companies. Since lending banks generally require a collateralised mortgage, the ability of real estate companies to finance themselves becomes further 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 affect 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.

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 divided into three categories.

Absence of systematic legislation and regulation

The development of REITs in China is faced with obstacles inherent to 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 (Trust Law) and regulations issued by the China Banking and Insurance Regulatory Commission (CBIRC)6 Measures for the Administration of Trust Companies and Measures for the Administration of Trust Companies’ Trust Plans of Assembled Funds. In relation to securities, there is a law (Securities Investment Fund Law), a regulation issued by the China Securities Regulatory Commission (CSRC) (The Administrative Rules on Asset Securitisation by Security Company), and a regulatory document (The Notice on Further Strengthening the Asset Management Services for Specific Clients Engaged by the Fund Management Companies and their Subsidiaries).

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.7

6 CBRC was integrated with CIRC into CBIRC in March 2018.
In terms of the practice of REITs in China, the current legal system is unclear 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 CBIRC 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 on the public capital market, which are not included in the regulatory scope of the CBIRC.

In the field of security law, Article 58 of Securities Investment Fund Law provides that fund assets shall 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 immovables, it is ambiguous whether REITs fall in 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 in the field of real estate finance, 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 Insufficient tax preferences

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 US. REITs in the US 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.

In 2002, the Ministry of Finance and the State Taxation Administration jointly issued 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\(^7\) in which the tax preference policy of funds was clarified. First, the price difference 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 difference income of individual investors serving as fund subscribing and redeeming entities before the levy of individual income tax upon the price difference income from their buying and selling stocks was recovered; third, with respect to the income acquired through 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.

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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, the individual income tax and enterprise income tax were not to be levied for the time being. Fourth, as for the 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 management of taxation by the Chinese government over funds and securities relies primarily on the issuance of temporary documents, resulting in an unstable tax policy.

Because Chinese tax collection has not been reformed and modernised, it is impossible to determine the amount to be taxed based on actual 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, the housing tax is inevitable once rents from the property are taken during the operation of REITs.

Asset transfers procedures are necessary for the restructuring of REITs. Therefore, if multiple taxation cannot be avoided, the profits of REITs products and other derivative asset securitisation products cannot be guaranteed to a desirable extent. Consequently, REITs cannot be successfully popularised in China.

### iii Legal uncertainty

Another obstacle that lies in the development of REITs is that REITs have not been regarded as a legal entity. At present, the investment fund is not a corporation, or even a legal entity, and investment collection is not regarded as a legal entity under Chinese law. In addition, no legal document has addressed this issue so far.

There is no clear definition of fund in the Securities Investment Fund Law, which is the only law related to funds. On the contrary, the legal system tends to define the fund as a collection of contracts. In this 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. This is against the theory of civil law, namely 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 in the Company Law effected on 1 January 2006 prescribe that the object of the company is the operation of the company and the company shall 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 operation 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 RECENT DEVELOPMENTS AND MILESTONES

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 that invests in a PE fund platform. The PE fund holds the equity of two project companies that separately own 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 its increase of 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 in ZhongXin QiHang. First, ZhongXin QiHang fails to meet the requirements for proceed allocation as ROI 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 not be less than 10 hands (50,000 shares/hand) and each transfer of secondary beneficiary certificate will not be less than one hand (300,000 shares/hand). 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 important property disposition for the ordinary investor. It is the excellent investment channel for minority investors that brings 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 certain and 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 ZhongXin QiHang, PengHua WanKe lowers the threshold of subscription and greatly increases its 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 will not be less than 100,000 yuan and additional subscription will not be 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 WanKe also includes an increase of the proceeding allocation ratio so that 90 per cent of annual allocable profits are allocated to the investors. However, similar 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, namely, no trust legal relationship has been established. As such, there is no establishment of a trust legal relationship and 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 above-mentioned three aspects indicate that owing to the lack of the required legal environment and the failure to adopt a complete trust structure, typical REITs in China are currently still a long way from the standardised REITs in the international market.

iii XingYe WanXin
XingYe WanXin YueJia Real Estate Investment Trust I is the first REIT publicly offered among banks. It obtained approval from the Central Bank of China in December 2016, and was officially offered in the national interbank market, the participants of which are commercial banks, insurance companies, securities companies, trust companies and other financial institutions.

XingYe WanXin was issued for a period of 18 years for a total of more than 553 million yuan, including 330 million yuan in Series A Preferred Securities (at the rate of 4.8 per cent per year) and 223 million yuan in Series B Preferred Securities (at the rate of 5.4 per cent per year). The underlying properties were the land and buildings of eight bookstores located in Anhui province, the rent of which would be used to pay for the interests of the preferred securities. The originator, WanXin ChuanMei or its affiliates may at the expiry of the REITs repurchase the properties to pay back the capital. The controlling shareholder of WanXin ChuanMei provided guarantees for the repayment of capital and interest, and the properties were also pledged for such repayment.

Compared to ZhongXin QiHang and PengHua WanKe, which were issued in the stock exchange markets, XingYe WanXin was a breakthrough in terms of its issuance in the interbank market. As all the participants were traditional financial institutions, which have sufficient funds and a lower interest rate requirement, this kind of REITs product is easily oversubscribed. At the time of issuance of XingYe WanXin, the subscription amount was twice the offering amount.

In contrast with standardised REITs, XingYe WanXin retains the characteristics of debt, emphasising fixed and guaranteed income. Although the product is offered publicly, it is only available to qualified financial institutions. In addition, there was no breakthrough in tax preferential treatment and perpetual term. This indicates that there are still fundamental differences between XingYe WanXin and standardised REITs in the international market.

iv Others
The REITs-like products in China have grown significantly since 2017 with the support of the government. Not only has the size of offerings increased rapidly, the products have also become diversified, such as the first long-term-lease apartments REITs – the China
Young Professionals Apartments REITs, the first rental housing REITs by state-owned enterprise – the Poly Rental Housing REITs and the first city improvement and modernisation REITs – the GoHigh City Renewal REITs.

Quasi-REIT products in China have been continuously improving in accordance with market demands. In January 2018, the China Insurance Regulatory Commission (CIRC) issued Measures for the Administration of Application of Insurance Funds, allowing insurance funds to invest in asset-backed securitisation products. In March 2018, various deputies of the National People's Congress (NPC) submitted proposals to the NPC and the National Committee of the Chinese People's Political Consultative Conference, suggesting that the government promulgate regulations for public REITs, support the REITs pilot projects and introduce REITs preferential tax policy. On 25 April 2018, the CSRC and the Housing Ministry voiced support for REIT pilot projects with the intention of supporting the residential leasing market.

On 27 April 2018, the Central Bank, CBIRC, and CSRC collectively issued Guiding Opinions on Regulating the Asset Management Business of Financial Institutions, increasing the regulation of asset management products, particularly on leverage, field of investments, and multi-layered nesting. However, asset-backed securitisation products are not subject to this regulation. Thus, in contrast with other traditional non-standardised products, asset-backed securitisation products such as REITs are inherently more flexible in its structure design, allowing the originator to standardise the non-standardised product in exchange for easier fundraising.

VI TRENDS OF REITS IN CHINA

Despite the advantages of REITs and the need for their implementation, so far no REITs that comply with the 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 US began with legislative activities in the 1960s, as was the case also in Hong Kong, Singapore and Japan. At present, 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 been putting 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, CSRC, CBIRC and the Ministry of Construction all intend to be the regulator of REITs. REITs was 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 CBIRC and the Ministry of Construction also want to be the regulator for REITs but they have similar problems to the Central Bank. The CSRC has a comprehensive system for the regulation of securities and funds in the Shanghai and Shenzhen Stock Exchange, and this makes the CRSC 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 the foreign REITs structure 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 in which the tax related to the contractual fund are exempted. Pursuant to the tax system in China, the revenue from the real estate operation shall 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. For the purpose of standardising REITs in China, tax exemption or tax preference policy should be established through special statutory issuance.

Third, a real estate property registration system should also be established. All investors have common ownership over the real estate property via REITs in the manner of securities issuance, which means ownership registration will be at issue. No restrictions for ownership registration will exist if the REITs are incorporated as a company. However, in terms of the current legal system, the Chinese government tends to develop contractual REITs, which results in difficulties with ownership registration. To ensure independence of ownership and achieve 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 LVAT and deed tax) that arises during property transfer, which will reduce the establishment and operation cost of REITs and subsequently facilitate the issuance and operation of REITs and mortgage financing.
I OVERVIEW OF THE MARKET

The Danish real estate market is mainly dominated by institutional investors and property funds, but real estate companies, of which the majority are privately held, are increasingly active in certain segments. The market for office properties is equally dominated by institutional investors, property funds and real estate companies seeking secure cash flows offered by the long leases usually attached to such properties. The residential segment is particularly dominated by property funds and real estate companies, with no notable presence of institutional investors, whereas property funds and institutional investors contribute the main part of investments in retail properties.

While the office, residential and retail segments have been predominant in recent years, investments in the hotel and logistic segments have recently begun attracting increased interest from investors following some years with slow activity. Transactions with hotel properties are increasing, particularly with institutional investors, domestic and foreign, being interested in this segment typically only investing in the hotel property and not the associated operations. Investments in logistics are also on the rise, especially modern logistic assets, which support the shift towards e-commerce, and are in high demand.

Domestic institutional investors have a significant presence in the Danish real estate market, where Danish pension funds in particular are increasing their investments in real estate. Pension funds are not only investing indirectly through property funds but are to a large extent investing directly in properties, including development projects, or providing financing by other means through various types of loans or bonds for acquisitions and development of real estate.

Recent years have seen an increasing number of foreign investors entering the Danish real estate market and in 2017 foreign investments surpassed investments from Danish investors for the first time. In 2018, Danish investments have again slightly surpassed foreign investments. The number of deals involving solely parties originating outside Denmark is also on the rise. Investors from Germany, Scandinavia, the US and the United Kingdom in particular are investing in Danish real estate with Swedish real estate investors especially being active in the Danish market and accounting for approximately one-quarter of the total investment volume in Denmark in 2018.
Foreign investors are mainly active in the retail segment, focusing primarily on retail properties located in prime locations, and the residential segment (mainly larger portfolios). However, they are increasingly interested in both office and logistics 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 entail 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.

II RECENT MARKET ACTIVITY

i M&A transactions

A notable transaction took place in 2017, where the largest transaction was made up by the real estate arm of Danish pension fund ATP’s acquisition of 50 per cent of a portfolio consisting of 16 shopping centres from another Danish pension fund, Danica Pension. The transaction is valued at 6.9 billion kroner and through the transaction the two Danish pension funds formed a joint venture which will develop and operate the centres cooperatively and potentially expand the portfolio through additional acquisitions. Danica sold real estate at a significant amount in 2017, also divesting an office portfolio to Wihlborgs Fastigheter AB at a price of 1.9 billion kroner and another portfolio of office properties to Swiss-based Woodman Asset Management for 1.6 billion kroner.

Recent years have seen several transactions involving larger residential property portfolios, with Swedish real estate company Heimstaden AB being by far the most active investor. In 2018, Heimstaden, among numerous other acquisitions, acquired the fund TG Partners III from Thylander Gruppen at a value of 1.52 billion kroner. The portfolio consisted of 25 properties divided into 1,400 flats, 50 commercial leases and almost 1,000 parking spaces inter alia located in Esbjerg, Aarhus and Kolding, which are larger Danish cities. Another notable transfer took place in 2018 when Heimstaden acquired three properties from FB Gruppen at just under 1.2 billion kroner. The properties are located in Copenhagen and comprise 489 flats of which 189 were student flats. The flats will be ready for occupancy at the end of 2019.

ii Private equity transactions

The largest Danish real estate private equity investment in recent years was carried out in May 2017 with Swedish Niam AB’s acquisition of all shares in Danish real estate company HD Ejendomme A/S from the founder family on undisclosed terms. HD Ejendomme owns and manages a portfolio consisting of both residential and commercial properties at a total value of approximately 4.2 billion kroner. HD Ejendomme was hit hard by the financial crisis in 2009 and struggled financially in the years following, causing a significant reduction in the portfolio. Simultaneously with the acquisition, Niam plans to recapitalise the company through an injection of new capital, strengthening the company financially as well as strategically.

In recent years, the Danish market for hotel properties has seen a number of significant transactions. The most prominent transactions were Solstra’s divestments of first the property housing the Copenhagen Marriott hotel in 2016 and next the Bella Sky property housing the AC Hotel Bella Sky Copenhagen in 2017. The Marriott hotel property was sold to
the Danish pension funds ATP and PensionDanmark, which paid approximately 1 billion kroner for the property, whereas the Bella Sky property was sold to the Norwegian private investor Wenaasgruppen for approximately 1.5 billion kroner. Prior to the divestments, the Solstra-owned operator of the hotels, which also operates another significant Copenhagen hotel, had performed a larger corporate restructuring, separating all its real estate assets from its operating activities.

Residential properties have also been in focus in the private equity market, with transactions involving larger portfolios. US private equity company Blackstone has been increasingly active in the Danish residential property market and has acquired residential properties at a total value of over 2.5 billion kroner in 2018.

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 by some distance is Jeudan A/S, with a market capitalisation of approximately 11.42 billion kroner, total assets of 24.3 billion kroner and annual revenue of 1.6 billion kroner.

Jeudan owns both commercial and residential properties in the Copenhagen area. Its portfolio primarily consists of commercial properties, including mainly office properties but also with some retail properties on central locations in the Copenhagen Area. Jeudan’s business strategy is to continue investing primarily in office properties in Copenhagen with a long-term investment horizon.

Besides Jeudan, only smaller real estate companies are traded publicly, none of which has a market capitalisation exceeding 600 million kroner, revenue exceeding 800 million kroner or total assets exceeding 2.6 billion kroner. These smaller companies do not play roles of major significance in the real estate M&A market, and only Jeudan is of a size to engage in larger transactions. However, Swedish public real estate companies are very active in the Danish market and are able to carry out large investments; mainly Heimstaden, Castellum, Akelius Residential Property AB, Fastighets AB Balder and Wihlborgs Fastigheter.

In 2018, US investment firm Castlelake made a conditional tender offer through its Danish subsidiary for the shares in BoStad A/S (previously named Admiral Capital A/S) with an advance commitment from Kvalitena Danmark AB, which owned 52.9 per cent of the shares and 63 per cent of the voting rights. Castlelake acquired the majority of the shares and voting rights in BoStad A/S through the conditional tender offer.

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, NREP and Core Property Management, which are all 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. In 2018, NREP announced a new fund, raising €900 million from mainly pension funds, insurance companies and sovereign wealth funds from the Nordics, Europe, the US and East Asia, making it the largest property fund in the Nordics so far.
Also the Danish operation of German fund Patrizia has been very active in recent years both in the retail and residential segments. Among the UK-based firms involved in recent major transactions are Coller Capital, Aberdeen Standard Investments, M7 Real Estate and M&G Real Estate. From Sweden, Niam and Svea Fastigheter have recently been party to significant transactions as well as CapMan from Finland. Furthermore, non-European players are also active in the Danish market, including amongst others US-based Blackstone and Hines.

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 by way of a transfer of the shares in the company. In contrast, when structured as an asset purchase, only the assets and liabilities that comprise 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 way of a partial 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 purchase price for residential properties. For other properties such
as commercial properties the variable registration fee is 0.6 per cent of the highest amount
of the purchase price or the latest public property value (as of 1 January 2020 the variable
registration fee will only be calculated on the basis of the purchase price). Registration of a
mortgage triggers a registration fee of 1,660 kroner plus 1.5 per cent of the mortgage sum
(from 1 July 2019 the registration fee is 1,640 kroner plus 1.45 per cent of the mortgage sum
with the variable component set to be lowered to 1.25 per cent of the mortgage sum from
1 January 2026); 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 and is widely used. However, the use
of drop-down should always be subject to an individual assessment in each case.

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 EU Market Abuse Regulation. The
duty to inform the market arises if information about the transaction constitutes inside
information. If information on a real estate transaction constitutes inside information, the
company is required to inform the public as soon as possible of the information, but with an
option to delay disclosure subject to certain conditions being met.

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

2 Inside information is non-public information that would be likely to have a significant effect on the price
of the company’s securities.
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 will typically include representations and warranties relating to, inter alia, the parties’ capacity to enter into the agreement, title to the shares, and that the shares are freely transferable and not subject to any encumbrances.

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 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 the property as well as easements registered on the property, and that there are no hidden defects.

Other representations and warranties by the seller may concern property insurances, 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. In a sale-and-leaseback transaction, conditions precedent to closing may include execution of a lease agreement pertaining to the property in question. The terms of the lease agreement will typically be agreed as part of the purchase agreement.

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, the 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 in regards to both time and amount (de minimis, basket and cap) and exclude liability for certain claims, for example, defects in the property, environmental and pollution matters, and the accuracy of particulars registered with public authorities.

It is becoming more and more common in larger Danish real estate M&A transactions that a W&I insurance is taken out in favour of the buyer regarding the potential liability of the seller for breaches of the warranties given in the purchase agreement. This is in line with a general trend in the Danish M&A market where W&I insurances are becoming increasingly popular. As a consequence, it is typically agreed in the purchase agreement that the purchaser may only direct a warranty claim against the insurer, and only in the event of wilful misconduct or fraud may the claim be made directly against the seller. The premium of the W&I insurance will often be borne equally by the each of the purchaser and the seller, but the purchase agreement may stipulate that either the purchaser or seller is to pay the full premium.

iii Hostile transactions

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

A 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 Danish mortgage system offers very low lending costs compared to the rest of Europe making it desirable to leverage investments in real estate, which is particularly attractive for property funds.

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 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.

Because of 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 generally 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 recaptured depreciations. However, if the seller is considered a professional real estate trader, typically due to multiple investments in real estate with a short holding period, the deduction of losses is not limited to profits on sales of real estate, but may be deducted from any other profits. 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 generally not trigger any capital gains tax on the shares if (1) the seller is a Danish limited liability company; and (2) 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 shareholder 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 under Danish tax law.

As a general rule, interest related to commercial activity in a company is tax deductible, but interest deductions may be limited by three sets of rules: the thin capitalisation test, the asset test and the EBIT test. 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 and generally either with or without permission from the Danish tax authorities. However, certain conditions will apply to the tax-exempt restructuring,
including a ban on selling the shares in the demerged or receiving company within three years of the restructuring. In general, it is possible, though, to obtain permission to carry out a tax-exempt restructuring without these conditions, provided that the contemplated transaction is commercially justifiable. Furthermore, it is worth taking into consideration that a tax-exempt restructuring may render tax losses carried forward from previous income years inapplicable as deductions against future income.

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 (going concern), for example, an ongoing rental business.

Generally, 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 and hotel sectors, private equity-owned companies have tended to separate the company’s real estate from the operating company 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, with a significant growth in volume in recent years. Several of the largest Danish companies have engaged in sale-and-leaseback transactions disposing of domicile properties to release capital tied up in real estate and focus resources on the core business with the potential to generate a higher return on capital. The acquirers are typically institutional investors and private equity firms. Sale-and-leaseback transactions are expected to continue at a relatively high level.

Particularly major companies within the financial sector has offloaded real estate and recent notable sale-and-leaseback transactions include Denmark’s largest bank, Danske Bank A/S’s, sale of its headquarters to Standard Life for approximately 1.4 billion kroner and Denmark’s largest mortgage credit institution, Nykredit Realkredit’s, divestment of its domicile, comprising two properties on the Copenhagen waterfront, to DADES at an estimated total of 1.5 billion kroner in 2016. In addition, industrial company Vestas Wind
Denmark

Systems A/S also sold its newly built headquarters to Solstra Capital Partners and Danish pension fund Sampension in 2017. In 2018, the mortgage credit company Jyske Realkredit A/S also sold its headquarters to the Danish pension fund PFA at a price of 640 million kroner.

VI OUTLOOK

It is expected that the focus on M&A and private equity transactions in the real estate market will continue. Additionally, the number of foreign investors in the Danish real estate market is expected to remain at a high level in the form of both private equity firms, property funds and real estate companies.

The total transaction volume fell in 2018 compared to 2017, but remains at high levels. Until recently, retail and residential properties have been the main focus of investments, particularly by international investors increasingly backed by foreign pension funds. Retail is especially challenged due to a surplus of retail spaces caused by the shift in shopping patterns toward online selling. Both domestic and foreign investors are increasingly directing their attention towards office properties, and this trend is expected to continue. The trend is expected to drive a further increase in the already high activity level of sale-and-leaseback of office properties held by corporations.

In addition to the main property segments comprising office, retail and residential properties, the hotels and logistics segments are seeing an increased interest. The hotel sector, in particular, is experiencing great investor attention, which is expected to continue with both domestic and foreign investors focusing more on diversifying real estate portfolios by investing in the hotel market and particularly Danish pension funds directing attention to the hotel market in the pursuit of stable yields. With the number of hotels, both high-end and budget, increasing rapidly, in particular in the Copenhagen area, this trend is likely to continue in the coming years, even though the transaction volume saw a significant decline in 2018, which was mainly attributed to the lack of supply of prime hotel properties. The rising interest in logistics properties are also expected to continue.

Transactions involving residential properties in Copenhagen have been the primary driver of growth in transaction volume since 2015. In 2018, some investors shifted their focus back towards the major cities due to increased anxiety regarding the financial markets, particularly in the later part of 2018 compared to 2017, where investors were targeting the secondary markets in search for higher yields.

The Danish legislation on residential rent regulation has recently gained political and public awareness due to an investment scheme used by investors. Under the investment scheme, the investor acquires old residential properties (erected before 1991), typically located in Copenhagen, and thoroughly refurbishes the flats, as this allows for a higher permissible rent when re-letting the flats. The political discussion has concerned a possible amendment of the current legislation on residential rent regulation, which could result in lower returns for investors. However, a bill on the matter has not yet been proposed.

Both institutional and private equity investors are expected to increase their focus on the development of new properties or value-adding through the development of existing properties. The focus on property development may entail a greater risk for investors, but also a greater return, which is increasingly important as the returns on existing properties are at low levels due to the recent significant activity in the property market and the lack of supply of relevant properties.
Chapter 8

FRANCE

Marcus Billam, Bertrand Cardi and Forrest G Alogna

I OVERVIEW OF THE MARKET

In 2002, France became one of the first major European countries to introduce a listed REIT regime, referred to as ‘SIIC’. The introduction of the SIIC regime provides listed property companies with a tax efficient regime, permitting them to unlock trapped value and attract significant investments. SIICs play a key role in the French real estate market, with an aggregate market capitalisation for French SIIC of approximately €70 billion in recent years.

A number of other investment structures designed for real estate investments are available, including SCPI and OPCI (a form of SCPI created in 2005, which is more flexible and provides heightened liquidity). OPCI (in the form available to qualified investors) tend to be the investment structure favored by sophisticated private equity funds for their non-public investments.

Both pan-European and French specific private equity funds focused on real estate are active in France, with significant portfolios of office space, as well as clinics, hotels, retirement communities, and student housing. Logistics have been a key deal driver in recent years. The last twenty years have witnessed an ongoing professionalisation and consolidation of the French real estate market.

France is one of the most attractive jurisdictions in the world for foreign investment, and real estate is no exception, with foreign investors, both from continental Europe and further afield, playing a key role.

II RECENT MARKET ACTIVITY

i M&A transactions


On 12 December 2017, Unibail-Rodamco, incorporated in France, and Westfield, incorporated in Australia, two of the largest REITs in commercial real estate, announced that Unibail-Rodamco had entered into an implementation agreement to acquire the Westfield Group to create one of the world’s premier developers and operators of flagship shopping destinations. The transaction implied an enterprise value for Westfield of US$24.7 billion. A year and a half later, on 5 June 2018, Unibail-Rodamco-Westfield Group’s ‘stapled shares’ were admitted to trading on the Euronext Paris and Amsterdam markets.

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1 Marcus Billam, Bertrand Cardi and Forrest G Alogna are partners at Darrois Villey Maillot Brochier.
2 SCPI currently reflect a total capitalisation as of the end of 2018 of a little more than €50 million.
3 Today they are estimated to include a total capitalisation of approximately €80 billion.
Among the many constraints of this transaction, it was necessary to maintain a tax regime that was generally equivalent to those of the two groups, even though their respective legal and tax frameworks were very different.

The Westfield group was acquired partly by Unibail-Rodamco and partly by a Dutch company WFD Unibail-Rodamco NV created for the occasion, in which Unibail-Rodamco held 40 per cent of the share capital (the remainder being held by the public) and whose shares were ‘stapled’ with Unibail-Rodamco shares, thus creating a two-headed group. The stapling principle means that the shares of Unibail-Rodamco and WFD Unibail-Rodamco trade as a single security.

To this end, the shares of the French company and those of the Dutch company held by the market are linked to each other by reciprocal provisions in the articles of association of each group prohibiting separate purchase and sale. This is not a dual-headed structure, since the shares are not separately and independently traded on separate stock exchanges. As a result, each company maintains its own legal personality, legal and tax regimes (and in particular the benefit of the SIIC regime in France and the FBI regime in the Netherlands). However, both companies maintain a common shareholding structure and, in light of the stapling and Unibail-Rodamco’s 40 per cent shareholding in WFD Unibail-Rodamco N.V., the group operates as a single financial group with accounting consolidation and global financing, which makes financial communication and rating at the group level similar to that of a traditional group. Finally, from the shareholder’s point of view, the stapled shares are listed under a single quotation line similar to traditional trading in shares of listed groups.

Thus, the new group benefits from the advantages of two-headed group structures (such as dual-listed companies and other complex synthetic structures permitting to benefit from the legal and tax regimes specific to companies based in two separate countries) without suffering from the main disadvantages inherent in these structures.


On March 2016, in order to create a new player in the service property sector, Eurosic, a SIIC, announced that it had entered into agreements and commitments accounted for a total of 79 per cent of Foncière de Paris SIICs’ share capital and voting rights. Specifically, Eurosic had entered into outright share and purchase agreements with shareholders representing 26.6 per cent of the share capital and voting rights of Foncière de Paris, as well as contribution commitments with Covéa group and ACM VIE relating to an additional 52.5 per cent. In total these agreements and commitments accounted for a total of 79 per cent of Foncière de Paris’ share capital and voting rights. This transaction was supported by Foncière de Paris’ supervisory board.

On March 11, 2016, Eurosic filed a tender offer for the shares of Foncière de Paris for (1) a price of €136 per Foncière de Paris share contributed, or, at each tendering shareholders’ election; (2) 24 Eurosic shares delivered for 7 Foncière de Paris shares contributed; or (3) 24 Eurosic OSRA delivered for 7 Foncière de Paris shares contributed.

This tender offer was cleared by the French Autorité des Marchés Financiers (AMF) on 27 April 2016 and the tender offer was opened on 19 May 2016.

However, on May 19, 2016, Gecina (which did not hold any shares in Foncière de Paris), another SIIC, also filed with the AMF a competing alternative tender offer to buy the shares of Foncière de Paris for (1) a price of €150 per Foncière de Paris share, or, at each tendering shareholders’ election; (2) six Gecina shares delivered for five Foncière de Paris shares contributed; (3) 24 Eurosic OSRA delivered for seven Foncière de Paris shares.
contributed; or (4) 23 Gecina OSRA delivered for 20 Foncière de Paris shares contributed. At that time, Gecina was strategically refocusing on office real estate, and this transaction was expected to provide €2.6 billion fully complementary assets for a geographical coverage of Paris.4

Gecina’s tender offer was cleared by the AMF on 13 July 2016 and the tender offer was opened on 29 July 2016.

The main shareholders of Foncière de Paris, notably Covéa and ACM Vie, reaffirmed their intention to contribute their shares in exchange for Eurosic shares, due in particular to the investment strategy and tax considerations. For this reason, but also because of the block of shares already held by Eurosic, Gecina’s competing offer was blocked due to its failure to cross the 50 per cent threshold.

Challenging the reiteration of the commitments made by Foncière de Paris’ main shareholders to contribute to a lower offer, the French Association for the defence of minority shareholders (ADAM) and Gecina submitted a request to the AMF to withdraw the clearance decision of Eurosic’s tender offer published on 27 April 2016.

The ADAM and Gecina respectively argued that the AMF’s clearance decision was obtained through fraud. According to them, the behaviour of Eurosic, Covea and ACM Vie, in particular because of the maintenance of the commitments to contribute to Eurosic’s ‘less expensive’ offer, characterised on the one hand a concert between these shareholders which had not been declared and on the other hand, the irrevocable nature of the contribution commitments entered into by Covea and ACM Vie for the benefit of Eurosic.

In response to their request, the AMF informed the ADAM and Gecina on 11 August 2016 that no fraud likely to justify the withdrawal of the clearance decision had been demonstrated. The AMF considered that shareholders were free to tender their shares to a first tender offer after having had the opportunity to revoke their contribution commitments in the event of a competing offer and that proof of the existence of a concert was not provided and would in any event have no effect on the financial characteristics of Eurosic’s offer.

ADAM and Gecina appealed the AMF’s decision before the Paris Court of Appeal in August 2016. All of ADAM and Gecina’s arguments were rejected on appeal.

Finally, in June 2017, Gecina announced its plan to acquire all the shares of Eurosic, after unanimous approval by its board of directors. This friendly transaction between Gecina and Eurosic was supported by Eurosic’s main shareholders, representing 94.8 per cent of the share capital, via the conclusion of firm agreements for the sale of blocks and commitments to contribute to the mandatory tender offer that would be filed thereafter.

Following the acquisition of the blocks of shares on 29 August 2017, Gecina held nearly 85 per cent of Eurosic’s share capital on a diluted basis and filed a tender offer with a cash and an exchange option. Following the tender offer, Gecina held 47,079,603 shares, which represented 99.67 per cent (Eurosic share capital post dilution from convertible bonds and excluding treasury shares) of the share capital of Eurosic, and 17,491,754 OSRA (Obligation Subordonnée Remboursable en Actions, a sort of convertible bond) Eurosic, representing in total 99.75 per cent of the diluted capital. Therefore, Gecina announced its intention to proceed to a squeeze-out and delisting to allow the transfer of shares and OSRA of Eurosic not already owned by Gecina.

ii Private equity transactions

AccorInvest (2017–2018)

In a novel transaction completed in 2018, Accor SA spun off the property ownership of its hotel real estate (HotelInvest) permitting the entry of long-term financial investors into that business, including two sovereign wealth funds, Saudi Arabia’s Public Investment Fund and Singapore’s GIC Private Limited, an institutional investor, Predica, and two asset management firms, Colony NorthStar and Amundi Immobilier, while maintaining its franchising and management activities as a separate business (HotelServices). The purpose of the transaction was to enable the Accor Group to acquire the resources and agility needed to accelerate the growth of its core business, finance its various development projects (including digital diversification) and expand its offer through targeted acquisitions. At the same time, the new structure was designed to permit AccorInvest to optimise its strategy for the development of the hotel portfolio.

The first step was an asset contribution by way of spin-off governed by the law on demergers. At the shareholders’ meeting on 30 June 2017, the shareholders approved (by a 99.67 per cent majority) the proposed creation of a new subsidiary, AccorInvest Group SA, a Luxembourg société anonyme, comprising all of the hotels operated by HotelInvest and dedicated to operating owned and leased hotels and managing the related hotel properties. This was accomplished through the contribution of all of the assets, liabilities, rights and obligations comprising Accor’s AccorInvest business in continental Europe.

The shareholder approval paved the way for the next stage in the project, whereby Accor sold a controlling interest in AccorInvest, while retaining a significant minority stake in its capital. Accor negotiated with a group of French and International investors, for the sale of a controlling stake in AccorInvest’s share capital.

On 31 May 2018 Accor announced that it had completed the sale of 57.8 per cent of the capital of AccorInvest to Public Investment Fund (PIF) and GIC, Colony NorthStar, Crédit Agricole Assurances and Amundi. Accor retained 42.2 per cent of the capital of AccorInvest. A shareholders’ agreement was entered into to govern relations between the investors and Accor.

For Accor, the transaction resulted in a gross cash contribution of €4.6 billion.

As part of the transaction, Accor and AccorInvest will maintain their close, long-standing relationship through very long-term partnership agreements. Commercial relations between the Accor Group and AccorInvest are governed by hotel management contracts describing Accor’s commitments as operator towards hotel owners on terms consistent with the contracts generally entered into between the Accor Group and third-party hotel owners. A separate management contract has been signed for each hotel, covering a period of between 15 and 35 years depending on the hotel category.

Accor, AccorInvest and their respective subsidiaries also entered into a master partnership agreement organising the preferred relationship between Accor Group companies and AccorInvest Group companies, temporary reciprocal exclusive rights and reciprocal tag-along and drag-along rights for hotels, describing the basis for possible transfers of hotels and hotel management contracts, and agreeing possible waivers of certain terms and conditions of the hotel management contracts.

The master partnership agreement also includes a five-year exclusivity clause prohibiting AccorInvest entities from entering into a management or franchise contract on any hotels with another hotel operator, the restriction being gradually scaled down over this period. In return for this exclusivity clause, the AccorHotels Group entities would have a five-year
obligation to offer AccorInvest companies a priority right to invest in any hotel acquisition or development projects and to enter into a hotel management agreement covering the hotels concerned.

**Foncia (2016)**

European private equity firms Eurazeo and Bridgepoint became shareholders of Foncia group in 2011 via a common subsidiary.

Foncia operates in residential real estate and property management services and in joint-property management, lease management and renting. Since July 2011, under the impetus of Eurazeo and Bridgepoint and its new management team, the group had radically transformed itself, focusing on service quality and innovation and completing more than 60 acquisitions. Foncia posted revenue of €696 million in 2015.

On 9 June 2016, Eurazeo and Bridgepoint announced that they had entered into exclusive discussions with Partners Group, the global private markets investment manager, with a view to selling Foncia in its entirety. Partners Group was leading a consortium of investors, including Caisse de dépôt et placement du Québec and CIC Capital Corporation, a wholly-owned subsidiary of China Investment Corporation, as well as Foncia's management team. The deal, involving the sale of the entire Foncia group, was concluded for an enterprise value of €1.833 billion.

In July 2016, the European Commission approved the takeover and the closing took place on 7 September 2016.

Partners Group announced that, following the acquisition, the Partners Group consortium will work with Foncia’s management team to continue Foncia’s successful strategy of consolidation in the French property management market, develop Foncia’s offerings in related product areas, and accelerate its international expansion.

**III REAL ESTATE COMPANIES AND FIRMS**

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

Only publicly listed companies can benefit from the SIIC regime. There are currently 28 such companies in France. The success of the SIIC model has permitted them to attract and retain strong management teams, contributing to the professionalisation of the real estate sector. Today, SIICs are present throughout France with around 20 million square metres of assets, 208,000 jobs supported in 2018 and €13.5 billion in planned investments by 2022.\(^5\) The bulk of SIIC investments are in major metropolitan areas, with a strong focus on offices and shopping centres. SIICs typically focus on office and commercial property, sometimes with a sector focus, including shopping malls and commercial centers, offices, convention centres and exhibition sites and hotels.

When entering the SIIC regime, an exit tax of 19 per cent must be paid on unrealised capital gains on assets held by the corporation. In addition, at least 15 per cent of the share capital and voting rights of the SIICs must be held by persons holding, directly or indirectly, less than 2 per cent of the share capital and voting rights. In addition, 60 per cent or more of the capital or voting rights may not be held directly or indirectly by one or more shareholders acting in concert.

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\(^5\) Les sociétés immobilières cotées, partenaires des villes, FSIF et PWC, juin 2019, p. 4.
Other real investment structures permitting the taxation of gains at the level of shareholders rather than at the corporate level are available, including the SCPI; however this structure has enjoyed less success than the SIIC structure. As investment funds, SCPIs are regulated as alternative investment funds by the French market regulator, the Autorité des marchés financiers (AMF), pursuant to the European AIFM Directive. Accordingly, SCPIs must be managed by a management company and approved by the AMF. Other structural protections are built into the SCPI regime, including requirements for an independent real estate appraiser approved by the AMF and a custodian.

At the end of 2018, there were 175 SCPIs in France. The total market capitalisation of the SCPIs represented €55.4 billion. Yield SCPIs typically focus on regular rental income, including offices and commercial real estate.

### ii Real estate PE firms – footprint and structure

Sophisticated private equity investors investing in real estate assets tend to prefer a variation of the SCPI structure called OPCI (the specific variation for qualified investors is the OPPCI (Organisme Professionnel de Placement Collectif en Immobilier) structure). Despite their name (which includes the term ‘collective’), they are now available even for a sole investor. Like SCPIs, they are regulated by the AMF and must be managed by an AMF-approved management company. Today they are estimated to include a total capitalisation of approximately €80 billion. An OPPCI must hold at least 60 per cent of its assets in real estate assets, and at least 5 per cent in liquid assets.

Private equity investors in France adopt a variety of classic strategies in relation to real estate, including investing in existing properties to improve the property profile or seeking to improve operations (for example in hotel franchises or clinics, where there is a management incentive aspect). Higher levels of leverage can often be achieved in real estate as compared to other forms of private equity investment in France.

### IV TRANSACTIONS

#### i Legal frameworks and deal structures

The only permissible consideration in a merger involving a French company is stock of the continuing corporation in the merger (subject to limited cash boot). Accordingly, ‘triangular’ mergers are not permitted under French law. For public transactions, the tender offer (including exchange offers) is by far the most common structure. Cross-border mergers are also permitted under European law, but remain cumbersome in practice.

Board members and senior managers and other corporate decision-makers are required to act in their company’s corporate interest. In addition, for publicly listed companies, the

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6 This may notably be attributed to the limitations resulting in SCPI having considerably less recourse to leverage than SIIC.
7 See https://www.pierrepapier.fr/indicateurs/les-chiffres-cles-des-scpis/.
8 This figure is 10 per cent for OPCI – i.e., those funds that are available to retail investors.
9 Nicolas Rontchevsky, L’utilisation de la notion de l’intérêt social en droit des sociétés, en droit pénal et en droit boursier, Bulletin Joly Bourse, 1 July 2010 No. 4, 355 ¶6.
AMF must be informed of any actions by the company that may cause an offer to fail. In addition, AMF regulations require that the bidder, the target, and their respective concert parties, must respect the free play of offers and increased bids. The AMF requires that the target of a public tender offer designate an independent expert to issue a fairness opinion on the financial aspects of the offer whenever such offer ‘could potentially create a conflict of interest’ within the board which might undermine the objectivity of the board’s recommendation or call into question the equal treatment of shareholders. A specific regime governs the issuance of such fairness opinions, including the expert’s ‘independence’.

ii Acquisition agreement terms

For block sales from major shareholders of a publicly listed company (including a SIIC) preceding a tender offer, sellers often request top up clauses. Support agreements (i.e., undertakings for a shareholder to tender its shares) are also authorised, unless they make any competing offer impossible (e.g., if they are irrevocable or have a break fee that is too dissuasive).

There is no obligation to enter into a formal acquisition agreement, although in practice the offeror, target (and in some cases its significant shareholders) will often seek to enter into an agreement governing the conduct of the tender offer and, where relevant, setting forth agreements with respect to the governance of the combined businesses after the transaction.

Any break-up fees (including any reverse break-up fees) must be considered to be in the best interest of the target. As a result, break fees given in the context of a negotiated business combination must be reasonable. There is, however, no express statutory or regulatory text on this topic and there is only limited jurisprudence.

Provided they are of limited duration, exclusivity agreements providing that the target’s directors will not commence discussions with other potential offerors are generally regarded as permissible. These kinds of agreement (and ‘no-shop’ provisions or ‘matching-rights’ provisions) can, however, be challenged on the basis that they violate the general principles of free competition between offers and competing offers.

Once an offer has been filed with the AMF, there are very limited circumstances under which the offeror may withdraw the offer. As a corollary, at the time that the offer is first filed with the AMF, the irrevocable obligations and undertakings of the offeror must be guaranteed by at least one investment bank, which files the proposed offer with the AMF on behalf of the offeror.

In general, once filed with the AMF, the offeror may only withdraw its offer under very limited circumstances, including in the event of a competing bid, or with the AMF’s prior approval if:

- the offer becomes without purpose, for example, in the event that previously competing offerors decide to initiate a joint offer; or

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10 AMF Gen. Reg. Article 231-7 al. 2 (‘Si le conseil d’administration ou le directoire, après autorisation du conseil de surveillance des sociétés concernées, décident de prendre une décision dont la mise en œuvre est susceptible de faire échouer l’offre, ils en informent l’AMF’).
12 AMF Gen. Reg. Article 261-1 I.
the target takes actions which ‘alter its substance’ (either during the offer or in case the offer is successful) or increase the cost of the offer for the offeror.\textsuperscript{14}

In addition, French tender offer rules permit only a limited number of conditions to the offer. The only conditions that may be included in an offer are:

\begin{itemize}
  \item[a] the offeror making a voluntary offer may condition the closing of an offer on a minimum level of acceptance by the target shareholders;\textsuperscript{15}
  \item[b] if the offeror simultaneously makes separate offers on two or more targets, the closing of one offer may be subject to success of the other offer;\textsuperscript{16}
  \item[c] to the extent such approval is required, an offer may be conditioned upon receipt of antitrust approval, with certain significant limitations;
  \item[d] in certain cases, where the acquirer requires shareholder approval (e.g., to issue shares or to approve the tender offer); and
  \item[e] the AMF may condition the opening of the acceptance period on the receipt of mandatory regulatory approvals.
\end{itemize}

\textbf{iii Hostile transactions}

As mentioned above, France has witnessed hostile takeover battles concerning public real estate companies, including most recently Gecina’s hostile bid for Foncière de Paris discussed above.

In addition, in 2011, Paris Hotels Roissy Vaugirard (PHRV) whose share capital was owned by Allianz (31.4 per cent), Covéa group (31.4 per cent) and Cofitem-Cofimur (31.1 per cent), announced that it had made an unsolicited offer for Foncière Paris France (FPF), a French listed real estate company. The first offer was filed on October 7, 2011 with a price of €100 per share. On November 29, 2011 PRHV filed a higher bid with a price of €110 per share.

As regards both bids, the target’s board, with the exception of the representative of Cofitem-Cofimur (acting in concert with PHRV) who dissented, concluded that the offer was not in the interests of Foncière Paris France or of its employees, shareholders and holders of securities giving access to the capital.

In 2014, France opted out of the passivity rule, so that the board of directors may take measures aimed at frustrating a hostile bid.\textsuperscript{17} This obviously provides companies with greater flexibility to negotiate with a potential bidder or an alternative acquirer or to refuse an offer they do not deem to be in the company’s best interests. However, any defensive measures adopted by a target in the context of a hostile takeover must be consistent with its corporate interest.\textsuperscript{18}

\textsuperscript{15} See Gen. Reg. art. 231-9 II. This is not permitted for mandatory offers. This minimum level of acceptance is necessarily above the automatic invalidity threshold, i.e., 50 per cent of the total number of equity securities or voting rights of the target. In addition, the AMF has rarely accepted a minimum condition above 66.33 per cent.
\textsuperscript{16} See Gen. Reg. art. 231-10.
\textsuperscript{17} C. com. Article L. 233-32. The board’s exercise of its discretion is subject to the principles of the AMF takeover regime, the articles of incorporation and the limits of the powers granted by the shareholders’ general meeting, as well as of the corporate interest of the company.
\textsuperscript{18} Article L. 233-32 code de commerce (any decision on defensive measures must be ‘within the limits of the corporate interest’). See also Article 231-7 AMF Gen. Reg. (‘Pendant la période d’offre publique,
iv Financing considerations

French law prohibits a target company from advancing any funds, granting any loans, or granting any security (pledge, first demand guarantee, guarantee, etc.) on its assets in furtherance of the purchase of its own shares by a third party.19 Accordingly, in the context of leveraged buy-out transactions, French law prevents in particular any target company from, inter alia, providing security for any loans taken out for the purpose of financing the acquisition of its own shares. Any corporate officer of a target company which has granted any advance, loan, or security in violation of the prohibition on financial assistance, may be subject to criminal sanctions20 and civil sanctions, and/or the concerned advance, loan, or security may be declared void. No ‘whitewash’ procedure is available to permit exceptions to this prohibition on financial assistance. However, the offeror can give a pledge over the shares to be purchased in the offer as part of the security package to its financing parties.

In light of the foregoing, certain post-acquisition transactions should be undertaken with caution (e.g., leveraging up the target to pay a post-acquisition dividend to the offeror, or the post-completion merger of the target with the acquisition vehicle).

In the case of real estate assets, the use of leverage to acquire the real estate directly (rather than a corporate entity that owns the asset) does not pose similar issues.

v Tax considerations

With regard to the taxation of shareholders, and more specifically for the French tax resident, several rates are considered depending on the case:

The distributed income and capital gains subject to income tax are taxed as income from movable capital and those subject to corporate income tax are taxed at the standard rate (33.33 per cent).

For capital gains on the sale of shares that are subject to income tax, the progressive scale of the income tax applies and those subject to income tax the long-term capital gains (PVLT) regime may apply if the conditions are met (qualification of equity securities and holding period). In this case a specific rate of 19 per cent is applied.

For shareholders who are not French tax residents, there is a 30 per cent withholding tax concerning the distributed income and capital gains. Concerning the capital gains on the sale shares, there is an ordinary tax rate of 33.1 per cent, with some exceptions (for natural persons, companies whose profits are taxed in the name of shareholders, community companies subject to corporation tax and certain real estate investment funds).

vi Cross-border complications and solutions

The direct or indirect acquisition by a foreign investor of the control of a French company involved in certain activities considered as ‘strategic’ requires the prior approval of the French Minister of Economy. Strategic activities include:

a cryptology, intelligence, military and defense;

b gambling, private security, wiretapping, IT security, dual-use items; and

l’initiateur et la société visée s’assurent que leurs actes, décisions et déclarations n’ont pas pour effet de compromettre l’intérêt social et l’égalité de traitement ou d’information des détenteurs de titres des sociétés concernées.’


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c the integrity, security and continuity of:
- electricity, gas, hydrocarbons or other energy sources;
- water supply;
- transport networks and services;
- electronic communications service networks;
- an establishment, installation or work of vital importance; and
- public health.

Certain variations are applicable to investors from within the EU. The French administration has been increasingly vigilant in its application of this regime, and so a conservative approach should be adopted in assessing whether the regime applies.

V CORPORATE REAL ESTATE

There are a number of precedents for separating corporate real estate from operating companies, including notably the AccorInvest transaction discussed above. Other examples include Mercialys (a SIIC created by Casino Group, which owns real estate assets comprised of specialised hypermarkets and shopping malls located on the Casino Group’s hypermarket and supermarket sites and cafeterias as well as some sites including franchised supermarkets or mini-markets rented to third parties), and Carmila (a SIIC created by Carrefour and dedicated to the development of shopping centres adjacent to Carrefour hypermarkets in France, Spain and Italy).

VI OUTLOOK

The fundamentals generally appear solid for French commercial real estate; demand for office and commercial space remains strong. In particular, prime real estate in central urban areas enjoys historically low vacancy rights. Worldwide investment levels remain high and interest rates are low. 2018 set a record for investments in commercial real estate in France, supported by significant levels of foreign investment. The conjunction of the foregoing factors would seem to militate in favor of continued strong levels of investment in France, and a resulting potential for M&A. That being said, uncertainty surrounding historically high prices, ongoing geopolitical issues (protectionism, Brexit, etc.) and questions about the sustainability of the current market highs invites caution. Perhaps as a result, levels of M&A in France, including in the real estate sector, have been muted thus far this year, in comparison to the exceptional performance in recent years.
Chapter 9

GERMANY

Stefan Feuerriegel

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 2019, the total volume of transactions reached a peak of about €80 billion in 2015. After showing a slight decrease in market activity in 2016, with a total transaction volume of about €66 billion, the volume increased to €72 billion in 2017 and €78 billion in 2018. Investors still see Germany as a ‘safe haven’ for real estate investments. As a result, Germany has become the top market for real estate investment in Europe about the same as the UK, which led the ranks for years, and France. The ‘big 7’ cities in Germany (Berlin, Frankfurt, Hamburg, Munich, Cologne, Düsseldorf, Stuttgart) still attract the biggest share in total volume, while the shares of emerging regions such as Leipzig, Dresden, Nürnberg, Erlangen and Fürth are constantly growing – especially with regard to housing properties. Demand from national and international investors is still strong, but cannot be met with an appropriate supply.

When it comes to the popular regions on the field of real estate transactions, political developments in the individual states and municipalities will increasingly come into focus in the coming years: while many municipalities have made greater use of legal instruments (such as pre-emptive rights) in order to influence the supply and price structure, especially in the residential property sector, Berlin, for example, plans to impose a five-year legal moratorium (rent-cap) on rent increases in the residential property sector in 2020. When asked about the biggest challenges in the coming years, market experts mention such political uncertainties as one key factor, which might influence investment decisions.

II RECENT MARKET ACTIVITY

i M&A transactions

In 2017 and 2018, the trend kept turning to the takeover of entire platform providers. Main examples are the acquisition of GLL by Macquarie and the takeover of WCM by TLG and the takeovers of Rockspring and Triuva, both by PATRIZIA.

In 2017, one of the trends in the market was a shift to large-scale portfolio transactions by way of share deals in the logistics sector. Three of the top 10 commercial real estate transactions by volume in 2017 were structured as such: the takeover of the logiCOR portfolio by China Investment Corporation (CIC) from Blackstone (€12.25 billion value of which €2.2 billion

1 Stefan Feuerriegel is a partner at Norton Rose Fulbright LLP and heads the German real estate practice. Special thanks to Mr Malte Meyer for his support during the research for the 2019 edition.
is said to pertain to German assets), the purchase of the Hansteen portfolio by a JV between Blackstone and M7 (€1.1 billion) and the takeover of Gazeley by Brookfield (€800 million). Even though this trend slightly declined in 2018, when the logistics sector accounted for two of the top 10 transaction by volume – the acquisition of the Optimus-Prime-Portfolio by Helaba Invest (€520 million) and the purchase of the Alpha-Portfolio by Frasers Property (€480 million) – a further price increase on the logistics sector is more than likely.

The biggest single asset transactions in 2018 were the acquisition of BUWOG by Vonovia (€2.9 billion), the complete takeover of Galeria Karstadt Kaufhof by Signa (€1.8 billion) and the purchase of the PFA-Century-Portfolio by PFA (€900 million).

In terms of volume, investment in office space remains the dominant asset class accounting for about 70 per cent of the investment into commercial real estate, whereas there is a slight shift away from retail to multi-family residential properties. Former niche asset classes such as hotel and logistics have become strong asset classes.

ii Private equity transactions

Generally, transactions into pure real estate have not been as attractive for private equity investors in recent years. Strong demand and the corresponding competition between investors have led to rising prices and falling yields. Thus, market activity has generally 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, recent market activity shows the growing interest of private equity investors.

The highest by volume in 2018 was the takeover of a portfolio of housing units in Berlin, Magdeburg and Brandenburg by Blackstone (€400 million).

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, to allow small investors to invest in real estate assets, a certain number of shares must be free floating (15 per cent; by the time of the IPO, 25 per cent), 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 REIT’s 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. They have been growing steadily, and currently aggregate a market value of €2.72 billion, while the biggest German REIT, Alstria Office AG, has a stock market value of around €2.25 billion. The other German REITs, such as Fair Value REIT AG and Hamborner REIT AG, play a smaller role in the market.

Some of the biggest German REOCs under German law are UnionInvestment, Deka Investment, Deutsche Bank AG and the fast-growing PATRIZIA Immobilien AG.

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2 Article 11(1) of the German REIT Act.
3 All figures as per the third quarter of 2018.
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. Most foreign investors prefer investments via Luxembourg structures, followed by Dutch law structures. German open-ended funds held around €80 billion-worth of property worldwide. They are very attractive for investors, especially for German pensions funds and small and midcap insurance companies.

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 portfolio management. Various distribution regulations were also implemented, and now also apply to private placements and not only to public distribution. Significant changes have been brought to the minimum holding as well as termination periods; thus, new funds can be managed with considerably lower liquidity ratios.

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 increasingly focused on by REOCs. Recent studies predict, however, that as residential construction is currently, and may in the future 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 had been rare in recent years; however, in 2017, market players like Blackstone have at the same time disposed main stakes at their share of Logicor logistics and invested jointly with joint venture partner M7 into the Hansteen logistic portfolio. Cerberus has invested in large-scale shopping centre Rhein Ruhr Zentrum. However, generally it seems to be fair to state that PE investors who are typically looking for higher yields will in the current market rather be selling than investing to investors who are generally willing to sacrifice high yields for lower risks (the German market as a safe harbour). However, given that Germany is one of the top three markets for investments into real estate in Europe being, together with North America and Europe, the main focus of interest for investment, bigger players such as Blackstone, Cerberus, Apollo and Patron Capital will have Germany on their watchlists. 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 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. An asset deal will always invoke real estate transfer tax (RETT) (see Section IV.v), while a share deal might mitigate it if properly structured. The rate of RETT depends on the location of the real estate, with rates in the 16 German federal states currently differing between 3.5 and 6.5 per cent. 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 noteworthy current development is that, according to a recent legislative proposal, such values are about to change to 89.9 per cent (for the sold interests), 10.1 per cent (for the minority shareholding) and at least ten years (with regard to the holding period).

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 props, 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, were direct mergers, whereas the transactions planned but not executed would have been share purchases (for hostile takeovers, see Section IV.iii).

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. Even though rising construction costs are expected to slightly damp the respective development, this form of investment is still becoming more and more attractive for investors: as supply cannot match demand, investors look for options to lock up attractive properties in an early phase of development. They are willing to tackle the risks connected with forward transactions by calling for careful drafting of agreements.

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4 Mostly around 5 per cent, but many states have recently increased this or announced increases.
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 does 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, mostly knowledge-based, are given. Typical warranties and representations include that there are no outstanding administrative orders with regards to the property; there are no written complaints by authorities that the current development does not comply with the building laws; and 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 corresponding real property from the seller to the purchaser, and also for transactions by way of an 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 the completeness and correctness of a list of lease agreements; the payments thereunder within the months or years before signing; and 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 the written form requirements. A breach of the written form does not mean that a lease agreement would become invalid, but both parties would be in a position to terminate the agreement becoming effective within six to nine 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 the date of its becoming due. Asset deal transactions need – as laid out above – to be notarised 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 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 to secure the transfer of property, and ensuring he or she has all the documents necessary 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 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 regard to property itself but also to the shares that are transferred have to be included. Typical guarantees include that:

- the shares exist;
- they are not encumbered;
- the share capital is fully paid;
- the current shareholders’ agreement is complete and correct;
- the company is not bankrupt;
- there are no intercompany agreements in place; and
- 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) to bring about maturity. Typical prerequisite requirements are a 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 upon, in recent months and years, caps of 5 to 10 per cent have become more frequent.

Terms for the prescription of claims vary mostly between 12 and 24 months after the 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 but in the past 36 months the market share of transactions involving a W&I insurer has significantly increased. 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

There are not many hostile transactions in the market in the past in the German market. 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 to offer to purchase the shares from the shareholders of Deutsche Wohnen AG. The offer had a volume of €14 billion.
February 2016, the required acceptance rate of 50 per cent had not been reached. Thus, the attempt hostile takeover failed. Since then, no major hostile takeover has become public in the German real estate market.

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 40 to 60 per cent. Moreover, finance by insurance 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. The German funds are restricted by regulation and are not allowed to finance higher than 50 per cent of the asset value: they typically do not finance higher than around 45 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 costs 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 – currently – at least 95 per cent of shares in a company owning German real estate. The rate of RETT depends on the location of the real estate, as rates differ 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 currently invoked when 95 per cent or more of the interest in a property company organised as a partnership (KG) is transferred to new shareholders. The same applies when 95 per cent or more of the shares in a GmbH are purchased by one purchaser (or related parties). 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.

It is noteworthy that the German legislator is currently in the process of amending the aforesaid legal provisions insofar as that the relevant (maximum) threshold for the percentage of interests or shares, which may be transferred free of RETT, is about to be be lowered to 90 per cent, which likewise affects an increase of the percentage of interest, which have to be held by a potential RETT-blocker, to 10.1 per cent. Furthermore, the holding period is

5 Article 11(3) of the German Real Estate Transfer Tax Code (RETT Code).
6 Article 1(2a) of the RETT Code.
extended from five to at least 10 (in certain cases even 15) years. In addition to all this, the legislative proposal includes a number of critical and highly complex transitional provisions, which have to be taken into consideration in each individual case and are about to leave practitioners with a rising need for (legal) advice. In this context it is not surprising that, according to the EY Trend Barometer 2019, a large number of industry experts expect the proportion of share deals on the real estate market to significantly decrease as a result of the legislative changes on RETT. 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 of between approximately seven 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: this requires that only real estate is 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 or the operating equipment of logistics centres. To avoid trade tax, propcos are usually separated from opcos, or the 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, therefore, common to use foreign corporations for the acquisition of German real estate having their place of management outside Germany.

It may also be possible to shift the place of management of a propco that was incorporated under German law (GmbH (limited liability company) or GmbH & Co KG (limited partnership with a limited liability company being the general partner)) to a location outside Germany to have a more robust trade tax structure. However, in this context there are discussions whether limited partnerships under German law can have their seat outside Germany. Having a liable partner with seat outside Germany, therefore, bears the risk of having the limited partnership dissolved or never properly set into force. Given the number of follow-up questions such as who is the right owner, even if the limited partnership has been registered as owner (potentially a non-limited) partnership under civil law, and how this ‘toxic’ limited partnership registered as owner in the land register is being properly represented, etc., structuring acquisition vehicles with limited partnership or the acquisition from such vehicles will take more diligence. The issue is currently not yet well known in the market, but the ‘toxic acquisition vehicle’ is expected to be one of the future hotter topics in transactions.

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

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7 Article 9, No. 1, Sentence 2 of the German Trade Tax Code.
under the Parent–Subsidiary Directive\textsuperscript{8} or applicable double tax treaties.\textsuperscript{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, 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 propco or 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 hotels with their FF&E by way of lease contracts.

VI OUTLOOK

The market outlook is still positive because of the consistently low interest rate and, therefore, cheap financing, and the positive economic outlook (due to the low unemployment rate and predicted economic growth of 1.7 per cent for 2020). Moreover, demand should be steady, as the consumer climate is positive because of very low oil prices and the 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. In addition, capacity bottlenecks and rising prices on the side of the building contractors as well as growing political uncertainties are likely to have a slight damping effect on the constant positive development during recent years.

With the Brexit negotiations ongoing, the greater questions regard its implications on the real estate market. Expected falling investments in the UK and an expected decline in UK property values may lead to the German, and other large developed markets such as France, being regarded as ‘safe harbours’. Investors may also expect rebound opportunities in 2019 depending on the outcome of the Brexit negotiations.

Under legal aspects, the toxic acquisition vehicle issue described above is to be expected to take more room in transactional work and structuring vehicles as well as structuring under the new real estate transfer tax regime entering into force beginning of 2020. In addition, the lack of residential space has led to fierce discussions about regulation by way of freezing period of five years for rental increase for residential units in Berlin.


\textsuperscript{9} Article 50d(3) of the German Income Tax Code.
Chapter 10

INDIA

Cyril Shroff, Reeba Chacko and Nagavalli G

I OVERVIEW OF THE MARKET

India has undertaken significant structural reforms and the result is evident in improved rankings by 23 positions in the World Bank’s ease of doing business index, and by 129 ranks in the ease of dealing with construction permits index.2

The overall economic outlook for the country is positive. The IMF has projected the GDP growth of India in 2019–2020 to be in the range of 7.3 per cent.3 The real estate sector is of considerable significance in the Indian economy as it contributed approximately 7 per cent to the Indian gross domestic product (GDP) in 2017 and is expected to contribute about 13 per cent by 2025.4

FDI equity inflows in the construction development sector stood at US$29.41 billion during the period April 2000 to December 2018.5 The private equity and venture capital investments in the sector reached US$4.47 billion in 2018, an improvement over the figures for private equity and debt investments for 2017 (US$4.18 billion) for the same period. Real estate was one of the top five sectors that private equity investment was made to in 2018.6

II RECENT MARKET ACTIVITY

The Indian real estate sector has witnessed high growth in recent times with a rise in demand for office, residential spaces and logistic warehouses. Salient reported on the activity in this sector, including the following:7

a In May 2019, private equity firm Warburg Pincus formed an investment platform with Mumbai developer Runwal Group with a total corpus of US$1 billion to develop shopping malls.

1 Cyril Shroff is managing partner, and Reeba Chacko and Nagavalli G are partners at Cyril Amarchand Mangaldas. Tax inputs from S R Patnaik and Mekhla Anand, partners in the tax practice. They were assisted by Travysha Darapuneni and Harish S, principal associates in the corporate practice.


3 https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD/IND.


5 Same as above.


7 The FIPB has since been abolished.
b In March–April 2019, Embassy Office Parks, India’s first real estate investment trust (REIT) went public. Embassy Office Parks is backed by global private equity Blackstone and Bengaluru based developer Embassy. With this event, India joins the list of elite countries like the US, Singapore, and the UK, where REIT units are publicly traded.

c In November 2018, Warburg Pincus-backed logistics developer ESR Group and German asset manager Allianz Real Estate, announced a joint platform to invest around US$1 billion in the logistics sector.

d In May 2018, Blackstone Group acquired One Indiabulls in Chennai from Indiabulls Real Estate for approximately US$136.9 million.

e Around 5.1 million square feet of retail space became operational in seven Indian cities in 2018.

f Warehousing space in eight Indian cities increased 22 per cent year on year in 2018 to 169 million square feet.

g Real estate players and investors are increasing their focus on co-working and co-living spaces, with co-working space across seven cities increasing sharply in 2018 (up to September), reaching 3.44 million square feet, compared to 1.11 million square feet for the same period in 2017.

h The government has taken an aggressive stance to promote affordable housing in the country, with measures including financial assistance of 2 trillion rupees (US$29 billion), lower borrowing rates, tax concessions and increased private investment.

III REAL ESTATE ENTITIES AND 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 mixed-use projects. Developers have also in the recent past focused on the development of full-fledged townships that 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 land owners. Large project requirements are also met through government-assisted acquisitions. Land is usually held through multiple special purpose vehicles (SPVs) holding real estate assets.

Multilevel holding structures are typically used for reasons of consolidation, corporatisation, ease of unbundling, ring-fencing project-specific risks, itemised scalability and future potential to list holding companies for fundraising.

Typically, investments are held through 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.

IV RAISING FINANCE

Avenues for fundraising in the real estate sector are fairly skewed as a result of regulatory hurdles and lack of confidence in developers given the manner in which the sector has been operated over the years.
Issues under various modes of financing

Bank debt
Under the domestic banking laws, scheduled commercial banks are restricted from lending for acquisitions of land. Further, a promoter's 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 the 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 had been active in this segment, but may have become more circumspect pursuant to the recent liquidity crunch.

External commercial borrowing
Recently, the Reserve Bank of India (RBI) consolidated all the erstwhile foreign exchange regulations governing the borrowing and lending in foreign currency or Indian rupees between persons resident in India and outside under the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018. These regulations have further eased the process for accessing overseas funds, however proceeds of external commercial borrowing (ECB) can still not be used for real estate activities. Construction and development of industrial parks, integrated townships, SEZ purchase, long term leasing of industrial land as part of the modernisation of expansion of existing units or any activity under the ‘infrastructure sector’ are not classified as real estate activity.

Public fundraising
From a public markets point of view, the track record of publicly traded real estate companies is less than good. However, given the positive response to India’s first REIT by both institutional as well as retail investors, public fund raising through REIT platforms is likely to gain more momentum.

Funding through bids
Since the introduction of the Insolvency and Bankruptcy Code, 2016 (IBC) the real estate sector has also seen investments being undertaken through a bidding process, with the winning bidder’s plan for resolution of the insolvency of the asset receiving judicial sanction. Recent amendments to the IBC envisage exemptions for testing the connected persons (as defined in the IBC) of pure play financial entities against each of the qualifying parameters. Further, in February 2019, RBI also permitted resolution applicants from raising ECB to repay rupee term loans of the corporate debtor, with prior approval of the RBI. The legal regime is evolving towards greater participation by financial investors in the resolution process.

Setting up REITs
The foreign exchange regulations have been amended to permit non-residents to invest in REITs, including by way of a swap of capital instruments held in an SPV (which holds the assets) for REIT units, thereby clearing a significant hurdle in setting up a REIT with
non-resident PE investors. However, the swap of non-convertible debt instruments for REIT units still requires approval of the RBI and could therefore continue to be a hurdle in case of investments made through debt instruments.

**Investment conditions**

Under the current regulatory framework, at least 80 per cent of the value of a REIT’s assets must be invested in completed rent-generating assets. The remaining 20 per cent is permitted to be invested in properties that are under construction or completed, but not for rent-generating purposes. While the general 80:20 classification is in line with the intent of providing more liquidity and ensuring minimal risk in the hands of a unitholder, 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 not substantially complete, or in the case of SPVs operating multiple office parks with some being under development, 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 restructuring costs.

Further, in instances where the manager or sponsor of a REIT is foreign-owned or controlled, the REIT would be deemed to be a foreign-owned and controlled entity, and all downstream investments by the REIT would be required to comply with foreign exchange regulations. Given that real estate is a significantly regulated sector, this could restrict the funding and investment options available to the REIT.

**Multiple SPV structures**

The REIT regulations permit up to two-layer SPV structures to be held by the REIT. Therefore, the requirement of complying with this requirement in cases where assets are held through multilevel structures involves significant restructuring of existing holdings.

**FDI**

While specific types of development-related activities are permitted, generally speaking, FDI is not permitted in real estate business (dealing in immovable property with the intent of earning profits), the construction of farmhouses and trading in transferable development rights. Exceptions to this are investments in construction development projects and the earning of rent or income from projects through the leasing of property (without transfer of the same). However, in 2018 it was clarified that FDI is permitted in real estate broking services.

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 (US$10 million for wholly owned subsidiaries and US$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 a 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 was also regulatory ambiguity with 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 the approval of the Foreign Investment Promotion Board (FIPB), which was not very forthcoming given the sensitivities around the sector.

In a significant overhaul in 2014, the present government eased the 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 the 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 by 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 the operation and maintenance of completed projects such as shopping centres and business centres were permitted. Thus, the FDI regime in construction development until November 2015 was marred by exit issues.

In November 2015, the government did away with most of the entry conditions for investment into a project. Investment can now be brought in for each phase separately, a dispensation that has significantly aided developers in obtaining phase-wise funding from different investors. Although 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 longer 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 other non-residents without a repatriation of funds, even during the lock-in period, without the requirement of obtaining any approvals from authorities in India. In addition, special economic zones and hospitals, where these sectoral conditions relating to FDI do not apply, and industrial parks (where there is a different regime of commercial projects), investments are now permitted in completed projects for the operation and maintenance of townships, shopping centres and complexes and business centres, subject to a lock-in of three years. 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 continue to increase.

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 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 sometimes arduous.

**Investment through listed non-convertible debentures**

The market is seeing a rise in the prominence of investments through listed and unlisted non-convertible debentures (NCDs) subscribed by foreign portfolio investors (FPIs) and

non-banking financial companies. From 2017 to 2018, the corporate bond market has raised about 5,990 billion rupees across 2,706 issues through private placement of NCDs. Under the Indian foreign exchange regulations, FPIs registered with SEBI are permitted to invest in listed or unlisted NCDs (subject to minimum residual maturity of one year, exposure (of a FPI and its related entities) to not more than 50 per cent of a single issue. There are end-use restrictions on investment in real estate business, capital market and the purchase of land, and conditions imposed by under the regulatory laws for such security). In February 2019, RBI relaxed the requirement of an FPI having exposure to not more than 20 per cent of the corporate bonds of a single issuer (or its related entities). 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.

RBI has recently on 1 March 2019, introduced a separate channel, called the ‘Voluntary Retention Route’ (VRR) for FPIs to invest in debt markets. Broadly, investments through the route have relaxations from certain regulatory norms (including the minimum maturity period, limit of 50 per cent exposure to a single FPI by a corporate debtor), subject to the FPI retaining a minimum percentage of its investments for a period. FPIs can choose to participate in this route, for which limits are made available through tap or auction.

In summary, with traditional debt funding through scheduled commercial banks and external commercial borrowings being in short supply, sentiment for publicly traded real estate companies being weak and REITs still in their infancy, investments (both equity and debt) in the real estate sector continue to be dominated by private equity investors.

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

A revolutionary change in recent times was the introduction of the RERDA, which seeks to protect home owner interests, ensure efficiency in property transactions, improve the accountability of developers and boost transparency in the sector, all of which have been lacking for a long time. RERDA prescribes registration of residential real estate projects, disclosures in relation thereto, and imposes restrictions on promoters and developers from changing building plans, or misusing the funds collected from allottees.

While the RERDA is intended to provide investors with much-required developer accountability and transparency, from the perspective of real estate companies, the regulatory burden and compliance costs have significantly increased, with certain conditions, such as the depositing of 70 per cent of funds, posing practical challenges. More importantly, as the implementation of RERDA is left to the discretion of the states, clear disparities have emerged between states, with regions such as Maharashtra and Haryana setting the benchmark in the industry.

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9 Protocol amending the Agreement between the Government of Republic of India and the Government of Republic of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment, signed on 10 May 2016.
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, inter alia, development milestones and lock-ins.

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. India’s FDI policy now specifically recognises foreign equity investment for the purposes of operation and maintenance of completed assets. The country has also seen significant restructuring activity in the sector from the point of view of making real estate spaces more marketable commodities: consolidating assets, segregating marketable assets, restructuring for raising finance, tax structuring, court-based mergers, demergers, conversion of LLPs into companies, restructuring partnership interests to permit investments and capital reduction, inter alia, 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 promoted structures and profit-sharing arrangements to incentivise developers. It is not uncommon in commercial projects to have asset or property management and development management arrangements with affiliates aimed as cash-outs to developers. Indemnity or holdbacks, escrow structures, representations and warranties and tax considerations (typically around capital gains and withholding taxes), inter alia, are sector-agnostic, and would apply to real estate investments and exits as well. Many investors who picked up significant stakes in the 2007–2008 bull run are now in exit mode. Owing to limited fund life and other constitutional concerns, PE funds are reluctant to give standard representations at the time of exit. While 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 investors, taking away from them the traditional knowledge exclusion despite their diligence).

ii Debt and structured debt
Investors are now looking at debt investments to gain an upside for their businesses 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 were common; however these have not been very prevalent in the last year due to the 50 per cent cap on FPI investment in each issue of debentures. These structures permitted 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; it 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 where 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 a cash coupon coupled with a 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 acquisitions, defaulting developers and the downgrading of their ratings have led to the sector being highly leveraged. Consequently, developers are now relying on private debt either as fresh debt or by way of refinancing an existing debt. With a high-risk appetite, PE players have shown interest and have invested in the NCDs of such companies. However, owing to the risks involved in such investments, such as delays in the completion of projects, projects under litigation and a general slackening of market demand for real estate, interest rates are substantially higher than those found in 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, and personal and corporate guarantees. Securing collateral for non-residential/ FPI investors is subject to the regulatory restrictions. The trend in securing a high return and easy exit is evidenced by way of redemption premium.

iii International taxation

In recent years, India has actively accelerated changes in the international taxation regime to accord compliance with the OECD Base Erosion and Profit Shifting (BEPS) Action Plans. Accordingly, India has undertaken introduction of several anti-avoidance measures in its domestic tax regime as well as in its bilateral Double Taxation Avoidance Agreements (DTAAs) with other nations.

In 2016 India entered into various protocols with the governments of Mauritius, Singapore and Cyprus to revise its DTAAs with these countries, to provide for source-based taxation of capital gains arising from an alienation of shares instead of a residence-based taxation with a view to preventing double non-taxation, curb revenue loss and check the menace of black money through an automatic exchange of information. However, the investments made prior to 1 April 2017 (i.e., shares acquired before 1 April 2017, including preference shares acquired before 1 April 2017, which may convert later) would continue to be taxed based on the principle of residence-based taxation (this is subject to a limitation of benefits clause in the India Mauritius and India Singapore DTAAs).

Significant other changes have been brought into Indian domestic tax legislation such as the Income Tax Act, 1961 (IT Act). Subsequent to the introduction of the concept of a place of effective management (POEM) for the determination of the residential status of the company, the government has issued final guiding principles for determination of POEM. Thus, foreign companies having a POEM in India, could be regarded as Indian tax residents,

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10 Third Protocol amending the Agreement between the Government of India and the Government of Republic of Singapore for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed on 30 December 2016.

11 A revised Agreement between the Government of Republic of India and Government of Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income, along with its Protocol, was signed on 18 November 2016.
and shall be liable to pay taxes in India on their global income and may not be entitled to any
DTAA benefits. Given the same, PE funds should ensure that the POEM is outside India
and for this purpose, all major decisions relating to the investment and divestment of Indian
securities should be taken outside India, and their fund managers should be located outside
India.

Furthermore, the provisions of General Anti Avoidance Rules (GAAR) became effective
from financial year 2017 to 2018 onwards. By virtue of GAAR, Indian tax authorities
have been empowered to declare any arrangement or transaction to be an impermissible
arrangement or transaction if they are of the view that the main purpose of carrying out
the said arrangement or transaction is, inter alia, for the purposes of availing a tax benefit.
Considering the wide ambit of GAAR, a number of legitimate business transactions could
come within its purview unless the taxpayer is able to establish its commercial substance
before the Indian tax authorities. The threshold limit for the invocation of GAAR is 30
million rupees. However, GAAR provisions are not applicable to income from the transfer of
investments made before 1 April 2017.

Another significant expansion of the scope of business connection, in line with BEPS
Action Plan 7, has also been introduced in India. Previously, a non-resident was said to
have a business connection in India if there was a person in India acting on behalf of the
non-resident, who, among other attributes, had the authority to conclude contracts in India.
However, as per the expanded scope, habitual conclusion of contracts or playing a principal
role leading to conclusion of such contract would also result in the non-resident having a
business connection in India.

iv Goods and service tax (GST)

Generally, developers prefer joint development agreements as it supports their capital-light
business strategy. Under the GST regime, while the government has exempted transfer
devices rights for residential projects, such transactions in commercial real estate
attract GST at the rate of 18 per cent per annum payable by the developer. Developers are
increasingly structuring their rights for tax optimisation.

v Taxation of REITs

Under the Income Tax Act 1961, REITs are accorded a pass-through status for interest income
received by the REITs from an SPV and also for rental income earned by the REITs. However,
a REIT is required to withhold tax at appropriate rates, whose credit can be claimed by the
unitholders against their final tax liability payable on the income earned from the REIT.

Where the assets in a REIT are held by an SPV, dividend distribution tax (DDT) of
approximately 20 per cent would be applicable to distributions made to the REIT, making
the structure tax-inefficient. However, no DDT is required to be paid for distributions made
by SPVs that are 100 per cent REIT-owned (or co-owned with a minimum mandated holding
by the co-owner under law), and such dividend received by the REIT and its unitholders shall
not be taxable in the hands of the REIT or its unitholders. 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 ventures.

Certain other issues that still require addressing from an industry standpoint include
the fact that the tax deferral scheme made available to sponsors on the transfer of SPV shares
to a REIT has not been extended to the direct transfer of assets and transfers of interest in LLPs; and that the holding period of REIT units has not been brought on a par with other listed securities at one year for availing of long-term capital gains benefits.

Conclusion

The real estate sector is slowly but steadily picking itself up from the lows of 2009 and 2010. Large platform deals and consolidation are an indication of growing confidence in the market by investors and developers. Greater number of listings on the REIT platform should bring further liquidity for investors and developers, and boost the real estate sector in India.

Use of technology is increasing in operation and maintenance of commercial and residential projects. Adoption of newer philosophies of co-living and co-working spaces, and student accommodation are steadily changing the landscape of the real estate sector.

Furthermore, the recently concluded general elections in May 2019, have given a clear mandate to the ruling party (Bharatiya Janata Party), and the real estate industry is expected to sustain momentum and growth, with further reforms on the anvil.
OVERVIEW OF THE MARKET

To date, Indonesia’s market for investment-grade real estate assets has been rather illiquid, showing very limited M&A and private equity activity. Many foreign investors consider Indonesia to be a risky place to do business. Until mid-2017, Indonesia’s credit ratings were 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 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, which following the President’s re-election in April 2019 will be in office for another five years, 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

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1 Emir Nurmansyah and Giffy Pardede are partners and Gustaaf Reerink is foreign counsel at Ali Budiardjo, Nugroho, Reksodiputro. The authors would like to thank Craig Williams and Anton Sitorus of Savills Indonesia for their valuable input on current developments in Indonesia’s real estate market as well as Linda Purnomo and Chaterine Tanuwijaya of Purnomo Consult for their comments on the tax implications of the real estate transactions discussed in this chapter.

2 Standard & Poor’s was the last of the three major credit rating agencies to raise Indonesia’s credit rating to investment grade on 19 May 2017. Recently, the three credit rating agencies increased Indonesia’s credit rating even further.
(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, a PMA company (as discussed in Section IV) or with a public listing. There are currently around 75 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 Sinar Mas. 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.

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; and

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 who 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, but increasing. Recent transactions include the acquisition in May 2018 by PT Waskita Karya Realty of shares in PT Mitra Mega Development from PT Green Orchid Berkah Madani. PT Mitra Mega Development is developing a project called Logios Apartments, which consists of apartments and three
towers totalling 1,640 units, on an 8,149 square metres plot in Depok. PT Waskita Karya Realty financed the transaction by the issuance of Medium-Term Notes. The total deal value was 880 billion rupiah.3 In May 2018, the Singapore listed company Perennial Real Estate Holdings acquired 100 per cent interest in Sanctuary City Pte. Ltd, which in turn holds a 60 per cent interest in PT Bhakti Bangun Harmoni. The remaining 40 per cent of the shares in PT Bhakti Bangun Harmoni are held by PT Cipta Harmoni Lestari. PT Bhakti Bangun Harmoni is the owner of 246,982 square metres of land in Sentul, Bogor. The company is developing Sanctuary City, a residential real estate project comprising houses and condominiums totalling 1,700 units. The consideration for the acquisition of Sanctuary City Pte. Ltd was US$15.6 million. The total development costs of the project are over 1.6 trillion rupiah, funded through residential sales, external borrowings and internal funds.4 In December 2018, Thailand based Strategic Hospitality Extendable Freehold and Leasehold Real Estate Investment Trust (SH-Trust) acquired from PT Agung Podomoro Land Tbky shares in PT Griya Pancaloka, a company that has the rights to develop and use the land to operate Sofitel Bali Nusa Dua Beach Resort, a five-star hotel with 398 guestrooms, 17 villas and facilities. Upon closing of the transaction, the REIT’s subsidiary, PT Griya Pancaloka, entered into a master lease agreement with PT Central Pesona Palace, the master lessee of Sofitel Bali Nusa Dua Beach Resort. The total investment amount was around 1.653 trillion rupiah.5

Several other M&A transactions in recent months involved property acquisitions. In July 2018, Singapore based UOL Group Limited, the parent company of Pan Pacific Hotel Group Limited, acquired 180 units at tower one of Thamrin Nine, a new property that is currently being constructed on a 5.4 hectares plot at Jalan Thamrin, the main corridor from Central to South Jakarta. Being 333.5 meters high and with 70 floors, tower one is said to become the highest building in Indonesia. UOL Group Limited will also manage 200 rooms of Parkroyal Hotel, a new hotel in the second tower of Thamrin Nine. The deal value was US$56.8 million.6 In September 2018, PT OUE Pengembangan Property, which is a subsidiary of Singapore real estate developer OUE Pte. Ltd., which is again part of the Indonesian conglomerate PT Lippo Karawaci Tbky, acquired around 8,000 square metres of land at Jalan Sudirman, South Jakarta’s main corridor and Central Business District, from local property developer Asia Tower Sudirman. The purchase price, which amounted to 1.63 trillion rupiah, was paid in the form of promissory notes.7 Another Singapore property

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developer, Keppel Land Limited, through its Indonesian subsidiary PT Sukses Manis Tangguh, acquired 7,700 square metres of land at Jalan Sudirman from PT Central Bank Indonesia Tbk. The land will be used to realise 400 luxury apartments. To total investment is estimated at 1.6 billion rupiah. In November 2018, Indonesian listed company PT M Cash Integrasi Tbk acquired from PT Kencana Graha Optima 1,663.59 square metres of office space at Mangkuluhr City-Office Tower One in South Jakarta. The purchase price amounted to 108.13 billion rupiah. In December 2018, PT Waskita Karya Realty, a subsidiary of PT Waskita Karya Tbk, acquired from PT Graha Ekatama 6,672 square meters of land in Serpong, South Tangerang. The total value of the transaction was 127.85 billion rupiah.

There is also a significant number of new projects on Indonesia’s real estate market. Most of these projects involve investment from foreign corporations through joint ventures with local companies. For example, Malaysia based developer Matrix Concepts Holdings Bhd, together with an Indonesian consortium comprising PT Bangun Kosambi Sukses (BKS), which is jointly owned by Agung Sedayu Group and Salim Group, and PT Nikko Sekuritas Indonesia (NSI), an investment bank, through their joint venture company, PT Fin Centerindo Satu, are developing an Islamic financial district in Pantai Indah Kapuk 2, not far from Soekarno Hatta Airport. The aforementioned company PT Cipta Harmoni Lestari, through its subsidiary PT Serpong Bangun Cipta, is also developing a housing project Serpong Banara in South Tangerang. In May 2019, real estate developer Sinar Mas Land announced its plans to develop Kazumi, a 2.8 hectares cluster of luxury housing that forms part of a 19 hectares estate called The Zora, in BSD City. The development is realised through Sinar Mas Land’s company PT BSD Diamond Development in collaboration with a Japanese consortium led by Mitsubishi Corporation. In May 2019, CFLD International (Indonesia), a subsidiary of the Chinese Industrial city developer CFLD, and the Singapore based Samanea Group, announced their plans to develop Tangerang New Industry City, a trading centre on a 7.6 hectares plot, in Tangerang District.

**ii Private equity transactions**

Private equity activity on Indonesia’s real estate market is very limited. A noteworthy transaction dates from a few years ago, i.e. the creation of joint venture company PT Nirvana Wastu Pratama (NWP Retail) by subsidiaries of Warburg Pincus LLC and the Indonesian public real estate company PT City Retail Developments Tbk (formerly called: PT Nirvana Development Tbk) in 2015. PT City Retail Developments Tbk specialises in

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9 See https://www.idx.co.id/StaticData/NewsAndAnnouncement/ANNOUNCEMENTSTOCK/From_EREP/201811/6316051a60_8370692bc3.pdf.
the development of hypermarket anchored retail centres in emerging cities across the country. As part of the investment, the private equity firm committed US$125 million, with the option to invest up to an additional US$75 million.\(^{15}\) In February 2019, NWP Retail raised another US$200 million from Warburg Pincus LLC as well as the Korean Teachers’ Credit Union and Citic Securities One-Belt-One-Road Fund. NWP Retail currently has 33 developments in Java, Kalimantan, Sumatera, Sulawesi, and Papua.\(^{16}\)

**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. In contrast to REITs, DIREs are not legal entities, but are based on collective investment contracts (KIKs). DIREs are regulated by the OJK. In December 2017, the OJK issued a new regulation on DIREs.\(^{17}\) Furthermore, in July 2016, it issued a regulation regarding DIREs based on shariah principles.\(^{18}\)

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). The 2017 OJK regulation introduced a new restriction that, of the DIRE portfolio’s net assets, at least 80 per cent must be real estate assets, while assets that are related to real estate may only be a maximum of 20 per cent. It is not possible for a DIRE to invest in vacant land. However, the 2017 OJK regulation now permits a DIRE scheme to invest in real estate that is under development as long as it generates revenue within six months of its ownership being transferred to the DIRE. Several restrictions apply in such case, including that the investments cannot amount to more than 10 per cent of the DIRE net value, there must not be any significant dilution of the DIRE’s revenue (i.e., 20 per cent of revenue or more) during the period of construction, and there must be no construction issues relating to the construction not being completed. It would also be possible for a DIRE to invest in a special purpose 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.

The maximum percentage for DIRE schemes to borrow funds is 45 per cent of the total value of the real estate to be purchased. Additionally, the 2017 OJK regulation now permits DIRE schemes to borrow funds by way of issuing debt securities. However, such issuance may only be undertaken for the purpose of purchasing real estate assets that have already

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\(^{17}\) OJK Regulation No. 64/POJK.04/2017 on DIREs in the form of KIKs.

\(^{18}\) OJK Regulation No. 30/POJK.04/2016 on Sharia DIREs in the form of KIKs.
generated revenue, and may only be worth 45 per cent of the total value of the real estate to be purchased. Just three DIREs are currently active in Indonesia. The first of these is DIRE Ciptadana Properti Ritel Indonesia, which has been listed on the IDX since 2013. It owns a shopping centre in Solo, Java. The second, DIRE Bowsprit Commercial & Infrastructure, was launched by Indonesian public real estate company PT Lippo Karawaci Tbk in early 2017 and has been listed on the IDX since March 2017. This DIRE’s funds have been used to acquire office towers and a distribution centre currently managed by PT Lippo Karawaci Tbk (Berita Satu Plaza in South Jakarta at around US$29 million, Menara Matahari in Tangerang at around US$39 million, Menara Asia in Tangerang at around US$29 million and Balaraja Distribution Centre at around US$34 million). An amount of around US$52 million has been used to participate in PT Mitra Wijaya Wisesa, which manages Life Tower in Kuningan, South Jakarta. The remainder, of around US$1 million, has been allocated as working capital. The third, DIRE Simas Plaza Indonesia, was listed by Fund manager PT Sinarmas Asset Management in July 2019. It has a total portfolio of 10.4 trillion rupiah (US$736.02 million). Contrary to other DIREs. DIRE Simas Plaza Indonesia does not use buildings, but shares in property companies as underlying assets. The underlying assets include a 95.37 per cent shareholding in the listed company PT Plaza Indonesia Realty, which owns and manages Plaza Indonesia shopping mall. The Plaza office tower and Grand Hyatt Hotel, all located in Central Jakarta, as well as a 100% shareholding in PT Sarana Mitra Investama, the parent company of the owner and manager of fX Sudireman shopping center, located in South Jakarta.

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 PT Lippo Karawaci Tbk. LMIR Trust has a diversified portfolio of 23 shopping centres and seven retail spaces across Indonesia. First REIT has a portfolio of 12 hospitals, two integrated hospitals and malls, one integrated hospital and hotel and one hotel and country club in various cities in Indonesia, in addition to several assets in Singapore and South Korea. In December 2017, LMIR Trust and First REIT announced their joint acquisition of an integrated development of hospital and shopping centre assets in Yogyakarta, Java. In February 2019, LMIR Trust acquired from PT Mandiri Cipta Gemilang, Lippo Mall Puri in West Jakarta for 3.70 trillion rupiah. It is said to be LMIR Trust’s largest transaction to date, resulting in an increase of its assets by 19 per cent from 19.51 trillion rupiah to 23.21 trillion rupiah. The transaction was financed with a combination of debt and equity financing.

We can conclude that DIREs are not very popular among investors. 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 of DIREs more attractive will change the generally negative sentiment among foreign investors regarding these funds.

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.25

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.26 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.

Until recently, a foreign investor wishing to establish a real estate company or purchase shares in a local real estate company required a licence from the Indonesia Investment Coordinating Board (BKPM). However, as a result of a new regulation that was enacted by the government of Indonesia in 2018, investors who wish to start their business in Indonesia are


26 See also Section V on foreign investment restrictions to companies active in providing integrated services for the support of facilities as well as cleaning services for buildings.
no longer required to obtain a licence from the BKPM, but can instead register their business through the Online Single Submission (OSS) system and obtain a single identity number (NIB). This new approach also applies to any existing Indonesian company, whether a PMA company with foreign shareholders or a local company with only Indonesian shareholders, including a local company which intends to convert its status to become a PMA company as a result from a transfer of shares from an Indonesian shareholder to a foreign shareholder. This NIB will serve as an Investment Registration Number, Importer Identification Number, Number of Company Registration Certificate, Social Security for Manpower and Social Security for Health Number, and Custom Identity Number. Once the company has obtained an NIB, the company may apply for a business licence or commercial or operation licence through the OSS system, provided the company meets certain requirements as set out in the new regulation.

Until recently, the BKPM regulations made a distinction between foreign investment companies engaged in the development and management of different types of property. However, following the issuance of a new BKPM regulation on 22 July 2019, this distinction no longer exists. Basically, a foreign investor who wants to set up a foreign investment company that is engaged in the development and management of property should invest more than 10 billion rupiah, excluding land and buildings, and the foreign investment company's issued and paid-up capital should be at least 2.5 billion rupiah with a minimum share participation of 10 million rupiah.

Before the shares in the local real estate company with only Indonesian shareholders are transferred, it will generally be required to amend the articles of association of the company; for instance, to increase the issued and paid-up capital to at least 2.5 billion rupiah. This amendment shall be made in notary deed form and be approved by the Minister of Law and Human Rights. These documents should be uploaded to the OSS system to obtain an NIB. Since the BKPM regulations have not been revoked, each PMA Company still needs to meet the requirements as set out in these BKPM regulations, including but not limited to submitting 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 through the OSS system.

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 the 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 of 25 per cent of the venture capital company's equity. Furthermore, this participation may only last for 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 multistorey 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 recent 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 should be invested; at least 2.5 billion rupiah of this amount should come in the form of equity.

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 movable 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.

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

Share deals

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.

<table>
<thead>
<tr>
<th>Object</th>
<th>Seller</th>
<th>Purchaser</th>
<th>Tax (applicable to seller) as gain on sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares in listed company</td>
<td>Indonesian / foreign company / individual</td>
<td>Indonesian / foreign company / individual</td>
<td>0.1 per cent of the transaction value</td>
</tr>
<tr>
<td>Shares in Indonesian limited liability company</td>
<td>Indonesian company</td>
<td>Indonesian / foreign company / individual</td>
<td>25 per cent corporate income tax</td>
</tr>
<tr>
<td></td>
<td>Indonesian individual</td>
<td>Indonesian / foreign company / individual</td>
<td>Up to 30 per cent (progressive rate for individual income tax)</td>
</tr>
<tr>
<td></td>
<td>Foreign company / individual</td>
<td>Indonesian / foreign company / individual</td>
<td>20 per cent x 25 per cent = 5 per cent final tax</td>
</tr>
</tbody>
</table>

To be withheld by the company which shares are being sold

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.

<table>
<thead>
<tr>
<th>Object</th>
<th>Recipient</th>
<th>Ownership</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>Local company</td>
<td>less than 25 per cent</td>
<td>15 per cent withholding</td>
</tr>
<tr>
<td></td>
<td></td>
<td>25 per cent or more</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>Local individual</td>
<td>Any per cent</td>
<td>Final tax 10 per cent (via withholding)</td>
</tr>
<tr>
<td></td>
<td>Foreign company / individual</td>
<td>Refer to the applicable tax treaty</td>
<td>20 per cent without tax treaty May be reduced with applicable tax treaty rate</td>
</tr>
</tbody>
</table>

Asset deals (land and buildings)

In the case of an asset deal, the sale of assets is subject to 10 per cent VAT. The transfer of land will trigger the obligation for the seller to pay income tax, which is 2.5 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 5 per cent of the purchase price of the land.

<table>
<thead>
<tr>
<th>Related tax</th>
<th>Rate</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added tax</td>
<td>10 per cent</td>
<td></td>
</tr>
<tr>
<td>Seller’s Tax</td>
<td>2.5 per cent of transaction value</td>
<td>Final income tax for seller</td>
</tr>
</tbody>
</table>
Aside from the above-mentioned tax in relation to the transfer, there are other taxes applicable to owning land and buildings. Land and building tax (Pajak Bumi dan Bangunan - PBB) is payable each year on land, buildings and fixtures. This is a regional tax and the rate is determined by the regional governments and therefore the exact rate will depend on where the assets are located.

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. 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 to the effect that: ‘Domestic investors and foreign investors who make investments in the form of a limited liability company are prohibited from entering into an agreement or making a statement asserting that share ownership in a limited liability company is for and in the name 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 is 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 for Indonesia’s real estate market are rather positive. Momentum is picking up. The effects of recent and ongoing pro-foreign investment measures by the Jokowi administration are already evident and are to likely have greater impact in the longer term. Having said that, it is likely that Indonesia’s legal framework will have to improve further before the country’s market for investment-grade real estate assets can achieve full potential.
Chapter 12

IRELAND

Paul Robinson,† Ailish Finnerty and Sophie Frederix²

OVERVIEW OF THE MARKET

The Irish real estate market continued to grow in 2018 and through the first half of 2019. Above-trend Irish economic growth is projected for 2019 and 2020 with Ireland remaining among the countries with the best GDP growth potential over the next five-year time horizon. Dublin is ranked third out of 31 European cities for real estate investment based on fundamentals in the market and rental growth prospects. The office sector continues to perform very well and sustained growth in the economy has brought unemployment down to 5.4 per cent in April 2019, its lowest rate for a decade. Ireland’s debt ratio, which had reached almost 125 per cent of GDP in 2008, has fallen to 68 per cent and is predicted to fall to the targeted level of 60 per cent by 2021. The budget deficit fell to 0.3 per cent of GDP in 2017. The government is planning a major capital expenditure plan (National Planning Framework) involving expenditure of €116 billion and this should enhance Ireland’s competitiveness with resulting impact on demand for real estate and real estate driven M&A transactions.

While real estate investment trusts (REITs) have been a feature of international property markets for many years, Irish legislation allowing for the establishment of REITs was only enacted in 2013.³ The three largest established REITs currently in operation under the Irish regime are: Green REIT plc (Green REIT), Hibernia REIT plc (Hibernia REIT) and Irish Residential Properties REIT plc (IRES REIT). Green REIT and Hibernia REIT both launched in 2013, while IRES REIT, a subsidiary of Toronto-based Canadian Apartment Properties REIT, launched in April 2014. The first three REITs initially raised €1.56 billion of debt and equity to buy up property in a market where commercial property prices had slumped by more than two-thirds from their 2008 peak. In June 2018, Yew Grove REIT plc became the fourth REIT and raised €75 million on initial public offering (IPO).

Irish REITs are predominantly held by international investors, and post-recession Ireland has unquestionably provided significant opportunities for REITs and their investors.

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†Paul Robinson was a partner at Arthur Cox. Paul passed away on 25 May 2019.

²Ailish Finnerty is a partner and Sophie Frederix is a senior associate at Arthur Cox.

³To qualify as a REIT in Ireland, a number of conditions must be met, including that it must:
   a be listed on the main market of a recognised EU stock exchange;
   b conduct a property rental business with a minimum of three properties (none of which have a market value in excess of 40 per cent of all assets held by the REIT), with at least 75 per cent of its income coming from such a business and assets of that business representing at least 75 per cent of its total assets;
   c meet a ratio of 1.25:1 of property income to property financing costs; and
   d distribute at least 85 per cent of its property rental income every year.
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. There is significant competition for commercial space in Dublin, evidenced by large letting transactions to Google, Facebook, LinkedIn and Salesforce. While ICT remains the dominant consumer of prime office space, international financial companies are now taking an increased share of space. In 2017, Lloyd’s of London insurer Beazley secured Central Bank approval to set up a European bank in Dublin and companies such as Citigroup, Bank of America and TD Securities have either announced expansion of existing Dublin base or Dublin as their new post-Brexit European hub. This activity continues to drive the demand for prime Irish real estate, particularly in Dublin’s central business district (CBD). Headline rental rates for prime offices in the CBD remain stable at €700 per square metre per annum.

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 ramped up investment in Irish real estate amid confidence that the economy had stabilised and returned to growth. Prime assets previously held by the National Asset Management Agency (NAMA, the state ‘bad bank’) and other credit institutions have now transferred to investors. Ireland’s economic recovery has re-established the country as an investable core market and accordingly, there is strong international investor demand for Irish real estate.

Following on from the flurry of secured loan portfolio and property acquisitions in 2013 to 2015, certain investors have recently signalled their intention to focus on development and asset management. Private equity players are partnering with local property developers and private equity players’ continued presence in the Irish market has led to the emergence of forward funding arrangements. For example, it was announced that Ronan Real Estate Group and its funding partners Colony Capital are seeking in excess of €250 million in forward-funding for a new housing scheme in the Dublin docklands. Forward funding transactions are particularly prevalent in the build-to-rent sector.

Activity in the residential investment market in Dublin was larger than the office and retail sectors in the second quarter of 2018. This is the first time that transactions in the residential market have overtaken all other investment classes. The residential investment market has grown strongly since 2016. It constituted just 6 per cent of the Dublin investment market in 2016, rising to 17 per cent in 2017 and standing at 24 per cent over the first six months of 2018.4

Retail accounted for 50 per cent of all investment transactions in 2016 including the sale of the Blanchardstown and Liffey Valley Shopping Centres for a reported €950 million and €630 million respectively. This contracted to 28 per cent in 2017 and a mere 3.3 per cent in the first quarter of 2018.5 However the food and beverage sector is experiencing strong demand with much of this coming from domestic Irish operators like Press Up Group, Mercantile Group and Fallon & Byrne.

In the first quarter of 2018, there were four hotel sales totalling €199 million including the sale of the Powerscourt Estate in Co. Wicklow to the MHL Group for €50 million.6 Some sizeable assets have come on the market including the Conrad Hotel guiding €115 million, the Marker Hotel, the Hilton Kilmainham Hotel, the K Club Resort and Druids Glen Hotel.

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4 Hooke & MacDonald Q2 2018 Report.
5 Colliers International.
6 CBRE Research.
Looking ahead, the economic prospects for Ireland are very good. The current expectation for GDP growth is 4.1 per cent for 2019 and 3.7 per cent for 2020. There are still risks to the Irish economy, which is closely tied to the global economy and to the UK economy. Brexit remains the largest risk and it is unclear what effect, if any, global tax reform will have on the Irish economy.

II RECENT MARKET ACTIVITY

i M&A transactions

2016, 2017 and 2018 have also seen a series of transactions in which property sales are structured as part of a transfer of a company. The most recent example is the sale of Jurys Inn Group Limited via share sale for €900 million. Other than that, 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. Between December 2011 and October 2017 this differential closed to 1 per cent. From 11 October 2017, the stamp duty rate on commercial real estate increased to 6 per cent. As a result, there is again a possibility of a 5 per cent differential between the rates of stamp duty. However, the opportunities for minimising stamp duty by structuring as a share sale will be limited by a new provision in Irish tax law that came into effect from 6 December 2017. This provision provides that in certain circumstances, sales of shares that derive their value from Irish commercial real estate should be subject to stamp duty at 6 per cent.

In light of their recent introduction in the Irish market in 2013, there have been no public takeovers or spin-offs of an Irish REIT to date. However on 15 April 2019 Green REIT put itself up for sale, citing a persistent gap between its share price and the value of its property portfolio. The process has reportedly been narrowed to four bidders – Irish Life, Kennedy Wilson Brookfield and German fund, Union Investment. The last public takeover of an Irish listed (pure) real estate company was the management buyout of Green Property plc in 2002.

Recent deals completed by REITs and Irish public companies include the following.

a In June 2018, Cairn Homes plc (Cairn) sold an apartment complex at Six Hanover Quay in Dublin to a company managed by Carysfort Capital for €101 million.


c On 13 June 2017, the state broadcaster, RTÉ, accepted a bid of €107.5 million from Cairn for 8.64 acres of land in Dublin 4, which it had been operating from since its establishment. Cairn plans to build 500 apartments and nine houses on the site. The deal closed on 17 July 2017.

d 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.7

e 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 Kennedy Wilson’s 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.

ii Private equity transactions

a In October 2018, Apollo acquired Goldman Sachs-backed Tifco for a reported €600 million. Tifco owns eighteen hotels and two sites in Dublin.

b Kennedy Wilson acquired a 50 per cent share in a mixed-use development in Dublin’s North Docks for €68 million from receivers acting for NAMA with joint venture partners AXA Investment Managers - Real Assets and Cain International.

c 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. Jurys Inn operates hotels in Ireland and the United Kingdom, and one hotel 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. Lone Star sold Jurys Inn for €900 million in late 2017 to Pandox and the Fattal Group. The acquisition was effected through the acquisition of Irish Incorporated holding companies. The remainder of Lone Star’s Amaris Hospitality group was acquired by LRC Group in July 2018 for €678 million. Typically these sales are business sales with the hotel as one of the assets comprised in the operation. Many of the recent hotel sales are as a result of PE investors exiting their investment.

d Colony Capital and Ronan Real Estate Group acquired Project Waterfront, a 4.6 acre site in Dublin’s Docklands from NAMA, for a price in excess of €180 million in October 2018.

e Blackstone acquired the Blanchardstown Shopping Centre in Dublin in June 2016 for a reported €950 million. The seller, Green Property, was one of the few listed Irish real estate companies before it was taken private in 2002. It remains privately held.

f In December 2016, a group led by US real estate investor Hines sold Liffey Valley Shopping Centre and adjacent lands to Germany’s largest public pensions group, Bayerische Versorgungskammer for €630 million.

Blackstone had previously acquired the well-known Burlington Hotel in Dublin for a reported €67 million in 2012. The Burlington Hotel was subsequently rebranded ‘Doubletree by Hilton’, and was sold to Deka Immobilien in August 2016 for a price reported to be in excess of €180 million. A record amount of €720 million was spent on 51 hotel transactions in Ireland in 2016. Deka Immobilien also purchased the Whitewater Shopping Centre in Newbridge, County Kildare, for €180 million from its joint owners, Ballymore Properties and Elm Holdings.

III REAL ESTATE COMPANIES AND FIRMS

Publicly traded REITs, property focused Plcs and REOCs – structure and role in the market

All 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 with the possibility to 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 ‘driving further risk-adjusted shareholder returns through the exploitation of the asset management initiatives and development opportunities within the portfolio’.

Hibernia REIT’s portfolio mainly comprises commercial and residential real estate assets. The value of Hibernia REIT’s properties climbed 8.7 per cent to €1.3 billion as at 31 March 2018. 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 rental 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 2,450 apartments and net assets of €618.7 million as at 31 December 2018.

Yew Grove REIT’s approach is to acquire ‘well-tenanted commercial real estate’ in its target market, which includes the CBD and the greater Dublin catchment area along with business parks and properties in major regional cities. It is, at this point, the smallest of the four Irish REITs.

Cairn, 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, and approximately €52 million following a secondary offering in May 2017. 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 in Ireland that are suitable

8 The property was purchased in 2007 for €288 million, which shows the extent of the collapse in property values in the recession.
9 Irish Times, 27 May 2016.
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.

Glenveagh Properties plc made an IPO in October 2017 and raised €500 million in capital. It is a house and apartment builder backed by US private equity firm, Oaktree Capital. By March 2018, it had invested almost €300 million of its IPO proceeds. It plans to build 2,000 houses and apartments a year in the longer term.

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 firms have also directly acquired and developed trophy assets, including Blackstone’s acquisition of the Burlington Hotel in 2012, and its acquisition of Blanchardstown Shopping Centre for around €950 million in June 2016.

Key private equity players in the Irish market include Blackstone (details of its activity are set out above), Kennedy Wilson, Apollo and Hines. Kennedy Wilson acquired Bank of Ireland’s real estate management business in 2011, and has become one of the largest property players in Dublin. Kennedy Wilson’s Irish portfolio includes high-end hotels such as the Shelbourne Hotel, Portmarnock Hotel and Golf Links (which is currently on the market for €50 million), 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. Hines Ireland best known acquisition is the former HQ of the Irish Central Bank, which it acquired in 2017 for €63 million. It intends to develop the former bank building as the Central Plaza, a city centre 12,500 square metre mixed-use scheme comprising offices, mixed use and retail.

In completing acquisitions, an Irish regulated fund is frequently used as the acquisition vehicle. This is now typically an Irish collective asset management vehicle (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 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 are under private contract, by way of a direct purchase of specified assets (asset purchase) or a 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 potential stamp duty saving in buying shares in companies holding real estate rather than directly buying the real estate assets (although it depends on the type of real estate). A private share purchase would not be regulated by the Irish Takeover Rules 2013 (Rules, considered in detail below), giving parties more freedom to agree the timetable of a 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**

A potential takeover of a REIT with shares admitted to listing on the Official List of the ISE 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 (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).

In 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 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.

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11 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.
**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 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 has 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 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 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, resulting in reduced administrative obligations and costs. However, as they are regulated by the CBI, there are higher establishment expenses and ongoing regulatory costs. From a tax perspective, ICAVs

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12 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.
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 (LPs)**

Another type of structure being used regularly for substantial property deals is the 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 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 that 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.

**Representations, warranties and indemnification**

In common with the 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 has 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.

Since 2016, Ireland has seen an emergence of ‘forward-funding’ deals in which investors agree to buy completed developments before or during the construction phase, enabling investors to obtain better returns while avoiding most of the development risk. In May 2017, JP Morgan acquired a 130,000 square foot building under construction in Dublin’s docklands. The building was developed by Kennedy Wilson and NAMA and structured as forward-finance deal for a reported €125 million. More recently, it was announced that Ronan Real Estate Group and its funding partners Colony Capital are seeking in excess of €250 million in forward-funding for a new housing scheme in the Dublin docklands. This trend reflects a shift away from opportunist investors snapping up prime properties at bargain prices to a market where longer-term investors take a risk that the developer will deliver a property on time and within budget.

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13 See footnote 4.
Another trend that has emerged since 2017 is alternative lenders entering the market. Credit availability is shifting away from solely traditional lenders to a mixture of banks, mezzanine lenders and non-bank lenders. Non-bank lenders are typically investors and institutions that are willing to lend and can include hedge funds, pension funds and insurance companies. Interest rates on non-bank lending are typically higher than those for traditional bank loans. At the end of May 2019, Twinlite secured finance of €90 million from the Cardinal Capital Group and Bank of Ireland to develop a build-to-rent scheme in North Dublin. This is the second residential development for Cardinal Capital – in February 2019 it provided funding to Chartered Land to acquire a €22 million site in Dublin 15.

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). A REIT is required to distribute 85 per cent of its property income annually. Irish-resident investors are fully liable to Irish tax on such distributions (save in certain cases, e.g., pension schemes or charities). In the case of non-Irish resident 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.¹⁵ Certain non-residents may be entitled to recover some or all of the tax withheld on distributions from the REIT under the provisions of a double tax treaty, or otherwise may 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. However, changes introduced in late 2016 now seek to impose a charge to tax where at least 25 per cent of the value of the total assets of the QIAIF, directly or indirectly, is derived from Irish real property assets (with certain exceptions), or where the main purpose of the QIAIF is dealing in or developing Irish land or carrying on an Irish property rental business. Where this occurs, in broad terms the QIAIF must apply a 20 per cent withholding tax on the occurrence of certain events, including the payment of distributions, cancellation, redemption or repurchase of units from an investor or the disposal of such units (again with certain investors excluded, e.g., certain pension funds). This applies irrespective of the tax residence of the investor.

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. These 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.¹⁶ Various deductions are available in computing taxable rental income, including interest on borrowings to purchase or develop Irish property, subject to certain requirements and restrictions.

¹⁵ 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.

¹⁶ Various deductions are available in computing taxable rental income, including interest on borrowings to purchase or develop Irish property, subject to certain requirements and restrictions.

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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 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 (currently 20 or 40 per cent, depending on the level of income).\(^\text{17}\)

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 a rate of 1 or 6 per cent on a share sale and at a rate of 6 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.\(^\text{18}\) 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 a 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. This is enforced by imposing at 15 per cent withholding tax on the consideration which must be withheld by the purchaser.

Ireland’s tax regime is currently undergoing significant changes due to OECD BEPS initiatives and related EU directives. The most significant of these from a real estate perspective is likely to be the introduction of an interest deduction limitation under the EU Anti-Tax Avoidance Directive. This is likely to be implemented with effect from 1 January 2021, and perhaps earlier.

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 or propco structures implemented in Ireland at the REIT or other large corporate level. However, these structures are now typically implemented at the individual asset level, primarily in the hotel sector but also in industries that have valuable property assets used in a trading capacity.

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\(^{17}\) They may also be liable for a pay-related social insurance and a universal social charge, although exemptions may apply in the case of non-Irish resident individuals.

\(^{18}\) 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 it is 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 expected to grow by 3.8 per cent in 2019 and 3.4 per cent in 2020, which is ahead of most eurozone countries.

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 the ability to execute transactions in the Irish market. However, while interest rates remain low, there are indications that the period of expansive monetary policy is drawing to a close.

The negotiations between the United Kingdom and the European Union in relation to the United Kingdom’s exit from the EU commenced on 19 June 2017. There is still no real clarity on the eventual form of the relationship between the United Kingdom and Ireland and the United Kingdom and the EU and it could take a number of years for clarity on this as the situation and negotiations appear to be entirely fluid. 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, especially if there is a ‘hard Brexit’ (i.e., no withdrawal agreement is reached). The next 24 months are likely to be volatile, but may present opportunities. In particular, as a result of Brexit, and the turmoil it has brought to British politics, many opportunities could arise for well-capitalised Irish REITs. Multinationals considering locating their European headquarters in the United Kingdom may decide to switch to Ireland, which, if and when Brexit is actually implemented, will be the only English-speaking Member State of the EU. Several financial services providers (e.g., JP Morgan) and other businesses have already announced their decision to opt to move certain parts of their operations from the United Kingdom to Ireland, while others are monitoring developments as the impact of Brexit becomes evident.
Chapter 13

JAPAN

Masakazu Iwakura and Takenobu Imaeda

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 because of the global financial crisis. Some years of stagnation 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 classes 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 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 2019, 63 publicly listed REITs are operating, with a total market capitalisation of approximately ¥14 trillion, with total assets under management of approximately ¥18.3 trillion. This is nearing the total market capitalisation of the 71 public real estate companies listed on the First Section of the TSE (¥13 trillion) as of April 2019.

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 this 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. Since then, five additional infrastructure funds have listed on the TSE.2

II RECENT MARKET ACTIVITY

i M&A transactions

In October 2015, Nomura Real Estate Master Fund Inc, one of the largest diversified J-REITs,3 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 tenth 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 DHI4 as the surviving corporation and DHR5 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 NMF6 as the surviving corporation and TOP7 as the absorbed corporation, with the effective date being 1 September 2016, and which would create the second-largest publicly traded REIT in Japan.

Recently there have been merger transactions between listed REITs having the same sponsor. In March 2018, Kenedix Residential Investment Corporation (KDR) and Japan

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3 With 261 properties and a total acquisition price of approximately ¥794 billion. As used in this chapter, ‘total acquisition price’ refers to the aggregate acquisition cost paid by the vehicle to acquire its real estate portfolio.

4 With 142 properties and a total acquisition price of approximately ¥256 billion.

5 With 41 properties and a total acquisition price of approximately ¥204 billion.

6 With 253 properties and a total acquisition price of approximately ¥795 billion.

7 With 20 properties and a total acquisition price of approximately ¥190 billion.
Senior Living Investment Corporation, a healthcare REIT (JSL), both having Kenedix Inc as sponsor, implemented an absorption-type merger, with KDR\(^8\) as the surviving corporation and JSL\(^9\) as the absorbed corporation; and one of the rationales of underpinning this transaction was to enhance the market visibility of a healthcare REIT, which typically have low market capitalisation. In addition, in May 2018, Sekisui House Reit Inc, an office-type REIT (SHR) considered to have insufficient dispersion in its portfolio, and Sekisui House Residential Investment Corporation (SHI), both having Sekisui House Ltd as sponsor, implemented an absorption-type merger, with SHR\(^{10}\) as the surviving corporation and SHI\(^{11}\) as the absorbed corporation, which resulted in the expansion of the REIT’s asset size and intended to have SHR be treated as a comprehensive-type REIT.

### 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 is controlled by 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 (JWD),\(^{12}\) 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 Public real estate companies and publicly traded REITs – 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 71 public real estate companies listed on the First Section of the TSE at the end of April 2019, of which Mitsubishi Estate Co Ltd has the largest market capitalisation of approximately ¥2.61 trillion. The average market capitalisation of the 71 public real estate companies is ¥184 billion.

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8 With 115 properties and a total acquisition price of approximately ¥164 billion.
9 With 14 properties and a total acquisition price of approximately ¥27 billion.
10 With six properties and a total acquisition price of approximately ¥200 billion.
11 With 113 properties and a total acquisition price of approximately ¥206 billion.
12 JWD is a leading Japanese wind farm developer and operator in Japan.
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 63 publicly traded J-REITs listed on Japanese securities exchanges, of which Nippon Building Fund Inc has the largest market capitalisation of approximately ¥1 trillion and a total asset acquisition price of approximately ¥1.1 trillion. The average market capitalisation of the 63 J-REITs is ¥223 billion, as of the end of April 2019, with the average total asset acquisition price being ¥291 billion.

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 J-REIT. While adopting this REIT structure under the Investment Trust Act has its benefits in attracting investors and raising funds (for example, because of it being a specifically designed structure for investment purposes that statutorily mandates certain mechanisms to protect investors’ interests), there is a long-standing theoretical concern over a potential conflict of interests between those of sponsors and those of unitholders. 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 unitholders’ meeting,13 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.

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13 A decision-making body within an investment corporation that consists of all its unitholders, which is permitted to vote only on matters provided in the Investment Trust Act or matters specified in the REIT’s articles of incorporation.
Listing requirements

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 unitholders 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 unitholders from taxable income for Japanese corporate tax purposes, subject to certain requirements under the Act on Special Measures Concerning Taxation. These 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 unitholders; 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 unitholder 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 two 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 five REITs listed on the TSE that invest mainly in hotels.

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 ¥157 billion as of the end of December 2017.

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.

**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, 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 transactions, as not all of the schemes available for M&A transactions concerning 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 transactions. For example, with respect to investment corporations, the

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15 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.
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&A transactions: (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 unitholders 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 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 unitholders. 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, the change must be approved at a unitholders’ 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 unitholders 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 in 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 unitholders at the unitholders’ meeting of both merging REITs. At the unitholders’ meeting, a vote by two-thirds or more 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, unitholder 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 unitholders 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 unitholder may demand that the investment corporation purchase its units at a fair value. However, in the case of a short-form merger, dissenting unitholders 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 unitholders’ 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:

- the trade names and addresses of the surviving corporation and the dissolving corporation;
- the number of units of the surviving corporation to be delivered upon the merger to the unitholders 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;
- matters concerning the allotment of investment units to the unitholders of the dissolving corporation; and
- 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 unitholders’ 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:

- specification of the shares to be transferred and the transfer price;
- closing of the transaction;
- representations and warranties;
- covenants;
- conditions precedent;
- damages and indemnification; and
- 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&A transactions or M&A transactions 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 United States and certain European capital markets, and, because of cross-shareholdings (though cross-shareholdings, which were seen frequently in Japan, have declined considerably), 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:

- purchase units of the target REIT through market transactions or takeover bids; and
- call a unitholders’ meeting to resolve, inter alia:
  - the cancellation of the asset management agreement between the target REIT and the existing AMC; and
  - 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 unitholder and its affiliates at the end of the fiscal period so (a) above is usually not practically feasible. In connection with (b) above, the articles of incorporation of an investment corporation often have a ‘deemed consent’ provision; while this provision’s application can be blocked by forcing the target REIT to have conflicting proposals submitted to the unitholders’ meeting, unless the hostile party forces the 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 the sub-bullets 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 owing partially to the fact that a hostile acquirer would need to solicit proxies from unitholders at its own cost.

However, as of the end of May 2019, Star Asia Group, through Star Asia Investment Corporation, a J-REIT, is trying to carry out a hostile takeover of Sakura General REIT Investment Corporation, another J-REIT, by seeking to convene a unitholders’ meeting so

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16 A provision to the effect that if any unitholder does not attend the unitholders’ meeting to vote and does not exercise its voting rights in writing, that unitholder shall be deemed to have voted in favour of the proposal submitted at the unitholders’ meeting.
as to consider the resolutions in the sub-bullets of (b) above. The Star Asia Group has asked investors in Sakura General REIT Investment Corporation to call the unitholders’ meeting, and the cancellation of the existing AMC contract and the conclusion of the new AMC will be on the agenda at that proposed unitholders’ meeting. In response to this unsolicited offer, Sakura General REIT Investment Corporation has shown strong willingness to oppose this and has called on investors to oppose Star Asia Group’s agenda. This potential hostile buyout has attracted much attention in the market in terms of whether it is the first hostile buyout offer of a J-REIT.

iv  Financing considerations
Where the acquirer is a stock company under the Companies Act, the acquisition may be internally funded by the acquirer or 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 the 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 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 this 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, 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.

Furthermore, in June 2017, the Ministry of Land, Infrastructure, Transport and Tourism (the Land Economy and Construction Industries Bureau) published a new action strategy for growth in the real estate investment market. This growth strategy points out that it is necessary to improve and enhance real estate investment through reforms to corporate real estate, the J-REIT market as a whole, the investment environment of real estate investors and human resource development in the real estate sector, in order to sustain attractive and stable growth of the real estate investment market. It is expected that the implementation of these measures in the near future would further promote the growth of the J-REIT market in the medium to long term, and 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.

Chapter 14

LATVIA

Gints Vilgerts and Vairis Dmitrijevs

I OVERVIEW OF THE MARKET

The Latvian real estate market can be described as a traditional market with mostly standard transactions. The most common forms of real estate deals are as follows:

a purchase of assets or business of the target company, including purchases of separate real estate or in combination with other assets (e.g., office building with all lease agreements);

b purchase of shares in the target company which in turn owns the real estate (it is common to incorporate additional special purpose vehicles into the overall holding structure);

c mergers or demergers of companies; and

d acquisition of the real estate by using a contractual joint venture.

Purchase of assets (business) and purchase of shares are the most common methods of structuring real estate deals in Latvia that are also preferred by financing banks. However, most of the high-value real estate transactions are engineered as sale of shares plus creation of a buying entity (with or without an in-kind investment of the real estate into the share capital of the target company) owing to a high real estate transfer tax (2 per cent from the value of the deal). Owing to potential high tax consequences, tax planning is a required part of any transaction.

In recent years, market activity has been stable, and no major changes have occurred. Investors from Scandinavia, the Baltic states and the United States are interested in investing in properties in the retail and office markets, thus transactions in the retail and office markets constitute most of the transactions in the wider market.

With respect to public real estate companies, real estate investment trusts (REIT) and real estate private equity (PE) firms, the Latvian real estate market deals with these entities from other jurisdictions when they acquire assets (business) or shares in target companies in Latvia. Usually, a local company is established for the management and development of the investment project in Latvia.

The industrial real estate market attracts mostly local and international companies in order to meet their business needs, and investments are made into real estate to improve their core operations. Real estate developers are active in the residential real estate market and a number of residential projects are underway. Apartments are sold mostly to residents, and in a substantially smaller proportion to non-residents.

1 Gints Vilgerts is a partner and Vairis Dmitrijevs is a senior associate at Vilgerts.
Activity in the land market segment has been steady and recent transactions continuously show positive trends in multi-apartment residential and mixed-use developments.

II RECENT MARKET ACTIVITY

In Latvia there are no official specific market and transaction reports, and usually information is gathered and reported by key players in the real estate market such as Colliers International and Ober-Haus Real Estate Advisors.²

i 2015

According to Colliers International, 2015 was a record post-crisis year in terms of investment;³ however, Ober Haus has a more down-to-earth opinion, indicating that in 2015 the number of deals and their value were at the same level as in the previous year.⁴ In any case, several transactions in 2015 are worth mentioning.

The top transactions in the retail market in 2015 were as follows:

a Blackstone Real Estate Partners IV, the largest real estate private equity firm in the world, acquired a real estate portfolio in Latvia (shopping centres in Riga: Alfa, Mols and Dole) from Norwegian Obligo Investment Management AS; as part of the agreement Blackstone entered into agreements with 10 funds managed by Obligo to acquire portfolios in Norway, Sweden, Finland, Latvia and Germany in an all-cash deal;⁵

b Partners Group, the international private capital company, purchased a real estate investment portfolio in Poland and the Baltic states, including the Olimpia shopping centre, from BPT Optima (subsidiary of the Danish investment company). The value of the transaction amounted to €163 million; and

c Hili Properties, a commercial real estate company headquartered in Malta, acquired nine retail centres throughout Latvia by purchasing shares in several target companies.⁶ The deal amounted to €22 million.

The top transaction in the office market in 2015 was the acquisition by EfTEN Capital, an independent Baltic commercial real estate fund manager currently managing three funds, of the Duntes Biroji Biznesam real estate. EfTEN entered the market in 2013, when it acquired a property near Riga, where it planned to build a local shopping centre.

² According to the most recent market reports of the key players in the region – Colliers International, Ober-Haus Real Estate Advisors, CBRE Group, ORDO Group etc. Available at www.liaa.gov.lv/en/business-latvia/real-estate-market-research (accessed on 19 July 2018).
The top transactions in the retail market in 2016 were as follows:

a Lone Star Funds, a global private equity and real estate investment fund, acquired Riga Plaza shopping centre. The value of the transaction amounted to €93.4 million; and

b EfTEN, an independent Baltic commercial real estate fund manager currently managing three funds, acquired the Domina Shopping shopping centre. The acquisition value was €74.5 million. The transaction was partly financed by Nordea bank in the amount of €45 million.

The top transactions in the office market in 2016 were as follows:

a Baltic Horizon Fund, an Estonian regulated closed-end contractual investment fund, acquired the Upmalas Biroji building;

b Laurus Fund, a joint venture of the clients of the Swiss investment company Partners Group and Northern Horizon Capital, acquired the Geneba portfolio consisting of 42 properties in Latvia, Lithuania and Estonia from Geneba Properties NV, a Dutch commercial real estate company. The most important properties in the sold portfolio were the SEB bank buildings in the Baltic states;

c Pillar Investment acquired the headquarters of AirBaltic for €6.2 million; and

d a group of private investors acquired the SWH Biroju Centrs building.

2017 was an active year with interesting transactions to report in the retail and office market, such as:

a the construction works of new shopping centres have commenced with completion expected in 2018–2019 (e.g., the Akropole centre in Riga, with a construction budget of €100 million);

b expansion of the existing Alfa and Origo shopping centres;

c a subsidiary of a Latvian shipping company sold the Preses Nams real estate to PN Project SIA, which is managed by Lithuanian real estate and private equity company Lords LB Asset Management. The transaction value amounted to €16.8 million; and

d in the office market: Z-Towers, Place 11.

Some of the highlights in 2018 were:

a East Capital Baltic Property Fund III acquired Galleria Riga shopping centre. The sellers of the center are Fritrade SE and Titan Invest A/S. East Capital Baltic Property Fund III is a real estate fund established by East Capital in August 2015. It invests in high-quality commercial properties with well-established tenants in attractive locations in Tallinn, Riga and Vilnius. The equity capital of the fund is €100 million, and it is targeted at institutional investors;

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b SG Capital acquired two office centres; 
c Eastnine AB acquired a business centre from LNK (according to public information 
the price was €24.8 million); and 
d East Capital Baltic Property Fund III acquired P5, a newly built A-Class logistics and 
industrial park in Riga, Latvia. The total transaction price for the property was publicly 
announced and amounted to €10.6 million.

Points (a) to (c), above, also made the top 10 deals in the Baltics in 2018.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market
REITs and REOCs from other jurisdictions are active in the Latvian real estate market. The said entities acquire cash-generating investment projects in Latvia and then manage and develop the projects by establishing local companies (usually private limited liability companies).

One of the REITs active in the Baltic states market is Baltic Horizon, which is the first listed Baltic REIT investing in commercial properties, including in Latvia. Baltic Horizon, which acquired an office building in Riga in 2016 (see above), is managed by Northern Horizon Capital AS, a subsidiary of Northern Horizon group. Northern Horizon Capital AS is a licensed alternative investment fund manager and is supervised by the Estonian Financial Supervision Authority.10

ii Real estate PE firms – footprint and structure
There have been no major real estate PE companies established in Latvia, but real estate PE firms from other jurisdictions, mostly EU based, are present in the Latvian real estate market.

IV TRANSACTIONS

i Alternative investment funds
Real estate-related operations of investment funds are regulated by the provisions of the Law on Alternative Investment Funds and their Managers.11 Real estate acquired by an investment fund must be registered under the name of the investment management company managing the fund. Assets of the fund may be invested in real estate located in Latvia, the EU, European Economic Area or Organisation for Economic Co-operation and Development Member States, or other countries, specified in the prospectus once the real estate has been valued and the valuation is approved by an independent expert panel appointed by the management company.12

10 www.baltichorizon.com/ (accessed on 26 June 2017).
11 In force, as of 7 August 2013 (as amended on 30 March 2017).
ii General overview of legal framework

The Latvian legal system is based on the civil (continental) law system. The main source of real estate law and civil transactions in Latvia is the Civil Law of the Republic of Latvia.

The main laws to be considered when entering into agreements in Latvia are, inter alia, as follows:

- the Commercial Law, which governs all company matters, including special commercial transactions;
- the Competition Law, which deals with merger control and all other aspects of competition law;
- the Group of Companies Law, which deals with company groups, holdings and multi-layered company structures;
- the Financial Instruments Market Law, if the companies’ bonds or shares are publicly traded;
- the Law on Governance of Shares and Companies of Public Bodies, dealing with, inter alia, sale of shares of public bodies;
- the Insurance and Reinsurance Law, governing acquisitions of shares in insurance companies or their portfolio;
- the Credit Institutions Law, governing transactions with the shares (or transfer of loan portfolios) in banks or similar financial entities; and
- the Insolvency Law, which applies if a target company is insolvent and distressed assets are acquired.

iii Deal structures

As was already mentioned, purchases of assets (business) and purchases of shares are the most common methods of structuring real estate deals in Latvia, and those will be discussed in more detail in this subsection. Because of high real estate transfer tax (2 per cent of deal value), most high-value real estate transactions are engineered as sales of shares after in-kind investment of the real estate into the share capital of the target company.

Purchase of shares

When purchasing shares in a target company, the main steps are as follows:

- Outlining the terms of the deal – the standard practice in all major business transactions is to sign a letter of intent (LoI) between the potential seller and potential buyer. The LoI outlines the terms of a deal and serves as an ‘agreement to agree’ between the parties, including price calculation method, time frame, confidentiality, exclusivity clauses and other provisions. In some cases the LoI only serves as a summary of agreed terms between the seller and the buyer. Therefore, the LoI can include provisions that are both binding and non-binding, although in a standard transaction the LoI is binding.
Due diligence process (DD) – once the LoI, or at least a confidentiality agreement is signed, the DD process commences, including legal, financial, technical, tax and other due diligence checks. The aim of the DD is to identify any potential risks that are likely to have a negative effect on the asset (business) or share value, and that need to be addressed in the share purchase agreement (SPA). Risks identified during DD can result with price adjustments, increased guarantees or even be a deal-breaker.

Negotiating transaction documents – in parallel to the DD process, the parties start negotiating the terms of the SPA and other transaction documents (e.g., corporate documents, financing documents – refinancing, pledges, etc.). In our practice, the first draft of the SPA is provided by the buy side.

Signing of the documents – when the parties have agreed on all terms and conditions of the SPA and other transaction documents, signing of those documents takes place. The transaction can be structured as a simultaneous signing and closing or as a deferred closing. Deferred closing is more common.

Payment of the purchase price – the standard practice in major business transactions is to open an escrow account in a bank (based on an escrow account agreement between the seller, the buyer and the bank), where the buyer transfers the purchase price. The funds are released from the escrow account in one or several tranches upon completion of specific conditions prescribed in the SPA and the escrow account agreement (e.g., resignation of the existing management board of the target company, termination of the agreements, completion of the constructions works, etc.), and the financing documents (e.g., registration of commercial pledges on the shares and assets, mortgage on the real estate, subordination of payments, etc.).

Closing the transaction – the time for closing the transaction is required for the seller and/or the target company to obtain any consents required for change of control or merger clearances, as well as to provide other documents and perform other acts required for closing, so that the title to the shares and control of the target company can be transferred from the seller to the buyer on the closing date. These include, for example, change of the target company’s management board to ensure transfer of control to the buyer on the closing date. Depending on the complexity of the transaction and the business type of the target company (e.g., whether it is a regulated company), and whether the purchase of shares of the target company is considered a merger under Latvian Competition Law, the time required for closing the transaction can vary from a couple of weeks to several months after signing the SPA and other transaction documents.

Registration with the Latvian Register of Enterprises – according to the Latvian Commercial Law, changes to the (1) articles of association, (2) the management board and supervisory board, (3) the legal address of the target company, and (4) notification of change of shareholders of the target company, and other changes are to be registered with or notified to the Register of Enterprises, or a combination of these. In particular, the buyer shall disclose the ultimate beneficial owners of the Latvian company in the public register.

Post-closing issues – there may be ongoing ties between the parties. Initially, it is likely that the parties will cooperate in determining the purchase price adjustment to reflect the amount of working capital or other net assets of the acquired company or assets at closing. The purchase price can also be adjusted if the seller’s representations and warranties turn out to be untrue.
**Purchase of real estate (assets or business)**

When purchasing a real estate, the main steps are as follows:

a. Signing of the real estate purchase agreement – the first step is the signing of the real estate purchase agreement. If the real estate is complex, it is possible that the parties sign an LoI or confidentiality agreement and carry out a DD process for the real estate, and enter into a purchase agreement only afterwards, as in share transfer deals.

b. Escrow account agreement – once the real estate purchase agreement is signed, the parties enter into an escrow account agreement with a bank, and the buyer transfers the purchase price or part of it to the escrow account. The funds remain in the escrow account until the parties have fulfilled all the conditions for the release of the funds, in one or several tranches.

c. Fulfilment of conditions – conditions that must be fulfilled by the seller or the buyer depend on the specifics of the real estate, but usually the seller needs to obtain refusal to exercise the rights of first refusal from the municipality or a third party; the seller must terminate certain agreements, etc.

d. Application to the Land Register – the parties sign an application to the Land Register for registration of the buyer's title to the real estate in front of a notary public. One of the parties, usually the buyer, covers the state and stamp duties.

e. Filing with the Land Register – the signed documents are filed with the Land Register. Usually the agreement sets strict time limits for each of the actions to be taken by the respective party.

f. Transfer of the purchase price – once the buyer is registered as the owner of the real estate, the bank transfers the purchase price or the remaining part of it to the seller's designated bank account. Mortgages and prohibition notes are registered or deleted depending on the transaction.

Please note that the above is only a general overview of standard and straightforward share purchase and real estate purchase deals.

**Portfolio deals**

Foreign investors enter into portfolio deals as they provide sufficient diversification and volume, a larger market share and reduce overall risk and relative costs.

iv. **Acquisition agreement terms**

The main terms of a standard acquisition agreement are, inter alia, as follows.

**Purchase price calculating methods**

One of the main provisions of the agreement is the method of calculating the purchase price and adjusting it post-closing.

**Transfer of title**

The title to the shares transfers when the new shareholder is entered into the shareholders’ register and the entry is signed by the relevant parties before a notary public or in the Register of Enterprises.
Conditions precedent

Conditions that must be fulfilled by the seller or the buyer depend on the specifics of the real estate or the target company.

Representations and warranties

These depend mainly on the DD findings reported to the buyer; there are standard representations and warranties (e.g., that the seller is the sole owner of the shares or real estate) and specific representations and warranties (e.g., with respect to patents, environmental issues and licences).

Governing law

In the case of private share and asset transactions, the parties may choose the governing law. However, some aspects of the transaction are always governed by Latvian law (especially in relation to registration of the shares or real estate transfer, as well as other mandatory requirements).

For instance, the Commercial Law prescribes the documentation necessary in the event of reorganisation (shareholders’ decisions, reorganisation agreement, auditor's reports, etc.) and what procedures should be followed (always ensuring that the interests of the shareholders and creditors are duly considered). In the case of a public offer, the necessary documentation and information to be included is prescribed by the Financial Instruments Market Law.

It is acceptable for a transaction to be subject to non-Latvian law, but owing to its connection with Latvia it might also be necessary to execute local transfer documents.

Dispute settlement

Latvia employs a three-tier judicial system. Alternatively, legal disputes can be settled by arbitration. In accordance with provisions of the Civil Procedure Law, any kind of evidence, including oral, is admissible. No evidence has priority over other evidence, and the court is obliged to assess any evidence provided by the parties.

In certain cases, the court may rule on securing claims of a financial nature prior to or during the proceedings. The security may include, inter alia, an encumbrance endorsement or a pledge-rights endorsement on real estate.

v Hostile transactions

The laws of the Republic of Latvia do not make any distinction between friendly and hostile transactions and the same regulatory framework is applicable in both cases.

vi Financing considerations

There is no special regulation with respect to financing for transactions in the laws of the Republic of Latvia and the parties are free to reflect on the financing method in the transaction documents. However, the choice of the financing method is based on various interrelated aspects – tax considerations (e.g., transfer pricing issues in case of related party financing, etc.), especially considering the new tax regime in force as of 1 January 2018, requirements of the financing bank(s), etc.

Obtaining financing by the buyer may be set as a precondition of the transaction. The financial provider may require registration of a charge (called a ‘commercial pledge’) over
the target shares or a mortgage over the real estate, which is usually required to be registered simultaneously with the registration of the share transfer or the real estate transfer. Typically, that requires the consent of the seller and its creditor, but in practice they are not supportive.

vii Tax considerations

Corporate income tax in real estate deals

Share transfers are generally corporate income tax neutral. However, asset deals (and sometimes also share transfers) could form the corporate income tax basis.

Non-resident companies are taxed on their Latvia-source income through permanent establishment at the standard corporate income tax rate. If no permanent establishment is created, non-residents may be taxed with 3.75 per cent withholding tax (WHT) for qualifying payments.

Acquisition of real estate

Non-residents are required to pay the standard rate that amounts to 3.75 per cent of the purchase price of the real estate, or the cadastral value of the property, or valuation for mortgage purposes, whichever is higher.

If a real estate is invested in the share capital of a company, the state fee is 1 per cent of the investment value. If a company acquires the title to the real estate because of reorganisation, the company is exempt from paying the state fee.

Sale of real estate

Several taxes may apply and those are:

a Value added tax (VAT) – sale of a new building is subject to VAT of 21 per cent. A building is not considered new, if at least a year has passed since the respective building has been put into an operation and the building has been used. In addition, in Latvia alternative VAT treatment exists – the ‘option to tax’.

b WHT – WHT rate of 3.75 per cent is applicable in case a Latvian resident company purchases real estate in Latvia or shares in a real estate company from a non-resident. Tax refund is possible.

c Personal income tax (PIT) – individuals, sellers of the shares may also be taxed at the rate of 20 per cent on capital gains.

d Transfer pricing (TP) rules are applicable if transactions (sale, loans) are between related parties. A transfer price must be at arm’s length. That means it must match the market price that two independent entities would apply in a similar transaction under the same or similar (comparable) conditions. Failure to do so might lead not only to tax surcharge but also penalties.

Real estate tax

Real estate tax is payable for all land and buildings in Latvia, owned both by individuals and companies. The local authorities in Latvian regions and towns are free to set tax rates on real estate in their area from 0.2 per cent to 3 per cent of its cadastral value, otherwise tax rates are defined by state apply. A tax rate exceeding 1.5 per cent of cadastral value may be charged only if the real estate is improperly maintained.
Tax due diligence

It is always advisable to carry out tax due diligence of the target company prior to closing of the transaction. If the accounting of the target company has been inaccurate in any aspect, then the risk is high that the Latvian tax authority will spot these inaccuracies during its audit and will impose a substantial fine on the target company.

viii Cross-border complications and solutions

Cross-border transactions are usually structured as sales of shares. Cross-border mergers are also possible, in which case the regulation on cross-border mergers prescribed by the Commercial Law (implementing EU directives) should be observed. Establishment of a European Company (Societas Europaea) is regulated by EC Regulation No. 2157/2001 (which is implemented by the Law on European Companies).

V CORPORATE REAL ESTATE

The Latvian real estate market is at an early development stage with respect to REITs and REOCs, and therefore there are no major and noteworthy transactions to report.

VI OUTLOOK

The economy in Latvia maintained its growth in 2018 and this positive tendency continues in 2019. It allows businesses to forecast that the market will remain active throughout the coming years. On a policy level, it is planned to continue improving the investment environment and legal framework governing the real estate market in Latvia, to make the industry more competitive. Representatives of the industry have undertaken to double the amount of annual investment in real estate by 2020 to achieve at least €600 million per annum, as agreed by and between the Ministry of Economics, the Ministry of Environmental Protection and Regional Development and representatives of the industry in the signing of a memorandum of understanding in 2017.21

Furthermore, the National Alliance of Real Estate Developers has undertaken to facilitate this contemplated increase in the volume of investment by 2020. This is likely to attract Nordic and international investors.

Chapter 15

LUXEMBOURG

Pierre Beissel and Stessie Soccio

I OVERVIEW OF THE MARKET

Development of the real estate market in Luxembourg

Before being a major financial marketplace, Luxembourg was initially an agricultural country. As the first EU country to adopt the European directive governing UCITS\(^2\) into national law in 1988, Luxembourg achieved a major turning point in its history by becoming the principal centre for investment funds in Europe and in the world. Luxembourg has emerged as the leading domicile in Europe for vehicles investing directly or indirectly in internationally diversified real estate portfolios. Currently, assets managed by Luxembourg investment funds represent (1) approximately 27.7 per cent of the total assets managed by investment funds in the European Union, putting Luxembourg in first place, and (2) approximately 9.1 per cent of the total market share worldwide, ranking Luxembourg second after the United States.

Its demographics and strategic geographical position have had an enormous impact on the real estate market in Luxembourg and this is set to continue. The demand for office and residential space is very high relative to the country’s size, and this is a main driver for continued growth. The total value of the office market in Luxembourg was estimated at around €23 billion in 2014. 2016 ended as the best year since 2007, exceeding the billion-euro volume for the first time at €1.016 billion, and 5 per cent higher than a year ago thanks to large transactions, primarily including office buildings.\(^3\) Based on projections provided by PricewaterhouseCoopers Luxembourg (PwC), this market is expected to grow by a compounded annual rate of 5.9 per cent until 2020, reaching a total value of some €32 billion.\(^4\) Within the Luxembourg real estate market, residential investment is by far the strongest. Its total value was over €122 billion in 2014 and it will continue to grow at a compounded annual rate of 5 per cent to nearly €158 billion by 2020.\(^5\) The rental market (focused on apartment letting) is also important in the Grand Duchy of Luxembourg but it is mainly concentrated in Luxembourg City and its neighbouring areas.

In the second quarter of 2018, 46 per cent of Luxembourg’s working population was composed of cross-border workers. This factor combined with the steady growth of the resident population explains the rapid increase of major infrastructure projects and strategic challenges. One of the main factors that guarantee sustainable growth for the Luxembourg real estate sector is the political and economic stability, which is key for foreign investors to

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\(^1\) Pierre Beissel is a partner and Stessie Soccio is a senior associate at Arendt & Medernach.

\(^2\) Undertakings for collective investment in transferable securities.


invest in the country, to set up their headquarter or European hub of operations. Following its growth in the past years, the investment market has become more and more international. Investors from Europe comprise 88 per cent of the market, with the remainder coming from the Americas, Asia and the Middle East.

**ii The Luxembourg market of real estate investment funds**

Although the number of real estate fund units has grown over the past few years, the number slightly decreased in the first three quarters of 2018 bringing the total number of real estate fund units domiciled in and operated from Luxembourg from 315 in 2016 to 310 in the last quarter of 2018. The annual Real Estate Investment Funds Survey by the Association of the Luxembourg Fund Industry (ALFI) in conjunction with Ernst and Young Luxembourg revealed that real estate assets under management in Luxembourg had reached more than €39 billion by the middle of 2015, up from €32 billion in 2014, and up to €70 billion in 2018. The year 2017 and the first half of 2018 were another very good period for Luxembourg-domiciled REIFs as the population expanded by 45 direct funds, of which 27 are manager-regulated alternative investment funds (AIFs) and 27 are reserved alternative investment funds (RAIFs) (as defined below). This brought the total number of REIFs surveyed to 304 vehicles, including 11 SICARs (as defined below), 27 manager-regulated AIFs and 27 RAIFs.

In 2018, 79 per cent of the 304 direct funds were created in the form of a Fonds Commun de Placement (FCP) (excluding investment companies in risk capital (SICARs)), usually in combination with the specialised investment fund (SIF) regime. The trend towards the FCP form has continued to reverse in line with the 2015 ALFI survey compared with findings from earlier surveys, since investment companies with variable capital (SICAVs) now account for 50 per cent of the surveyed funds. The most recent development in legal structuring has been the updating of the limited partnership laws in Luxembourg in 2013 (SCS and SCSp) with 97 funds reported (32 per cent) in 2018. Since the introduction of these new laws, the number of SCS or SCSp funds and other regulated vehicles has significantly increased, while the set-up of FCPs has decreased. The SCS and SCSp are very attractive because of their flexibility and alignment with common law-style limited partnerships.

In 2016, new funds were launched overwhelmingly by initiators/AIF managers (AIFMs) from Europe, with German, Benelux, UK and US initiators being the most active. The most common target sector remains the ‘multi-sector’ with 38 per cent (compared with 40 per cent in the ALFI 2017 survey). Among the sectors themselves, the categories ‘retail’, ‘office’ and ‘residential’ are almost equally represented this year, with 14 per cent, 10 per cent and 16 per cent respectively. Of the direct funds surveyed, 77 per cent invest in Europe, 6.6 per cent invest globally and 7.9 per cent invest in the Asia-Pacific region.

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7 A manager-regulated AIF refers to an investment fund that is not established under a regulated fund regime in Luxembourg (e.g., SIF/SICAR), but instead is formed solely under corporate or partnership law. The managers of such a vehicle are typically themselves regulated or registered directly under the AIFMD (as defined herein).
II RECENT MARKET ACTIVITY

Since 2014, while a major return of German institutional investors and French insurance companies within real estate transactions has been observed, the most striking factor has been the arrival of many investment funds from the United States and even the Middle East. It is for this reason that while Union Investment and Axa have been constantly increasing their presence, Blackstone, Starwood and Moor Park Capital have made a highly visible entry, and a sovereign fund, the Abu Dhabi Investment Authority, or ADIA, has acquired the project that will change the face of Luxembourg city centre.

i M&A transactions

Some of the most significant M&A transactions of the past few years (local and international deals) are summarised below.

Local deals

Acquisition of several lands in Luxembourg by Eaglestone

The Belgium promoter Eaglestone has established itself on the Luxembourg market since 2016 by acquiring several lands of ‘first choice’ to develop mixed real estate projects (office, retail and residential). Its last acquisition was in July 2019 in the Cloche d’Or neighbourhood for a total of €40 million.

ii Private equity transactions

Local deals

Sofitel Luxembourg

The Luxembourg-based investment firm Batipart acquired a six-hotel portfolio totalling 902 rooms, from compatriot CMIL, previously known as the Continental Motor Inn Luxembourg, in August 2019. Batipart has acquired the leasehold interests of the 109-room Sofitel Luxembourg Europe, the 260-room Novotel Kirchberg, the 110-room Novotel Suites Luxembourg and the 145-room Mama Shelter currently under development, as well as and the freehold interests of the 128-room Sofitel Luxembourg Le Grand Ducal and the 150-room Novotel Luxembourg Centre. The portfolio corresponds to an investment of over €70 million.

International deals: Luxembourg as a hub

Acquisition of the Liffey Valley Shopping Centre in Dublin

In 2019, Germany’s largest public pension group Bayerische Versorgungskammer (BVK) acquired Liffey Valley Shopping Centre and seven hectares of adjacent development land in west Dublin from the former owners Hines, HSBC Alternative Investments and the Grosvenor Group for over €600 million. The acquisition was made through a Luxembourg umbrella fund structure, organised as a specialised investment fund with variable share capital in the form of a Luxembourg limited partnership (BAYK Immobilien-Dachfonds 1 SCS SICAV SIF, sub-fund Elektra 2) that, at present, directly owns several Irish special purpose vehicles that in turn own the shopping centre and the development land surrounding the shopping centre.
Acquisition of Anson House in Singapore

In another landmark deal of 2019, BVK used another one of its Luxembourg fund vehicles, BVK-Pan-Asien Immobilienfonds FCP SIF, to acquire the entire share capital of the Singapore-based Yongjin Holdings Pte Ltd, a holding company that owns a commercial property called Anson House in Singapore that is primarily used for office rental and sale. The total acquisition was approximately S$210 million.

III REAL ESTATE COMPANIES AND FIRMS

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

No REIT legislation and no publicly traded REOCs

Even though Luxembourg does not have REIT-specific legislation or publicly traded REOCs, its existing investment vehicles – whether regulated or not – offer the flexibility required to favourably structure real estate investments for a variety of investors in a plurality of target countries. It is often the combination of the different vehicles that offers flexible and tax-efficient investment structures for pan-European real estate investments.

Listing of real estate investment structures on the Luxembourg Stock Exchange (LuxSE)

Listing the widest range of securities in Europe, including shares, units, warrants, global depositary receipts, certificates or debt securities, LuxSE offers an attractive trading platform for real estate investment structures. It provides a strong regulatory framework in line with the EU Directives on securities markets, allowing access to a fast, flexible and secure listing process, as well as to timely and transparent information thereby building strong foundations on which to raise funds and build investor confidence. Listing in Luxembourg is relatively straightforward and flexible. A listing agent is not mandatory.

ii Real estate PE firms – footprint and structure

Legal framework for real estate PE firms – introduction

Luxembourg is often used as the location of choice of professional, institutional and private investors for companies acquiring real estate. The choice of the legal form and regime will depend notably on (1) the target investors, (2) the investment strategy pursued, (3) the tax components, and (4) the marketing strategy. The Luxembourg legal framework also encourages the development of real estate funds and is diverse and flexible to meet a wide range of investor needs, and the Luxembourg taxation regime is a key factor when considering whether to choose an unregulated or regulated real estate investment vehicle for international investors.

AIF qualification

Luxembourg real estate investment vehicles, whether regulated or not, may qualify as AIFs within the meaning of the Alternative Investment Funds Managers Directive (AIFMD). The AIFMD was transposed into Luxembourg law by the law of 12 July 2013 on alternative investment fund managers (the AIFM Law). The AIFM Law regulates AIFMs, but it also contains various provisions applicable to qualifying AIFs, regardless of whether the AIF has been set up as a regulated vehicle or as a non-regulated vehicle.
Regulatory framework: regulated versus unregulated structures

Regulated structures are those fund vehicles that are authorised and supervised by the Commission de Surveillance du Secteur Financier (CSSF). The primary law applicable to regulated funds is the law of 17 December 2010 relating to undertakings for collective investment (UCIs Part II), as amended (the 2010 Law). The UCI Part II is the sole regulated real estate vehicle that can be offered to retail investors, subject to the compliance with the 2010 Law providing certain protections to investors in such a vehicle.

The 2010 Law is complemented by the law of 13 February 2007 on SIFs, as amended (the SIF Law). Interests in funds that are subject to the SIF law may only be sold to ‘well-informed investors’. In addition to the usual market of institutional and professional investors, this opens SIFs to high net worth individuals who meet the requirements of the SIF law. Though not specifically designed for real estate, the SIF offers a great deal of flexibility, which makes it a very appealing real estate investment vehicle. The SIF is not restricted to real estate investments. SIFs are not subject to general investment restrictions but must ensure adequate risk of diversification and disclosure. With the 2007 SIF Law, Luxembourg has also been able to cope with the great demand for alternative investment vehicles from investors around the world. This is reflected in the significant number of regulated funds investing in real estate assets that have been created under this regime.

There is also another Luxembourg vehicle, the SICAR, which is not classified as a fund but aims at directly or indirectly contributing assets to innovative projects with value creation at the level of portfolio companies (e.g., development projects, refurbishment) without being subject to risk-spreading requirements.

Unregulated vehicles are typically set up as companies or partnerships under the law of 10 August 1915 on commercial companies, as amended (the 1915 Law). They often take the form of a private limited company (Sàrl), a partnership limited by shares (SCA) or a limited partnership with or without legal personality (SCS or SCSp). When companies have as their main purpose the holding and financing of participations in other companies (which in their turn may own real estate), these companies are often referred to as SOPARFIs. While unregulated vehicles operate in a manner similar to regulated funds, unregulated vehicles offer greater flexibility (for example, in terms of choice of service providers) and lower set-up and operating costs (as opposed to investment vehicles subject to regulatory oversight and restrictions). Regulated vehicles benefit from, among other things, a favourable tax status and a high level of investor protection. Although not specifically designed for real estate, the time-efficient nature of the SOPARFI makes it very suitable for real estate. It is not subject to risk-spreading requirements nor is it restricted to any specific types of investments.

Unregulated vehicles tend to have a small group of investors and a simple capital structure. Notwithstanding the foregoing, unregulated vehicles may have a greater total size than regulated funds with more investors.

Finally, the reserved alternative investment fund (RAIF) vehicle was introduced by the Luxembourg law of 23 July 2016 (the RAIF Law). The RAIF, which is also subject to the 1915 Law, combines the characteristics and structuring flexibilities of Luxembourg regulated SIFs and SICARs qualifying as AIFs managed by an authorised AIFM, except that RAIFs are not subject to CSSF approval before they are launched. This new structure is viewed as complementing Luxembourg’s attractive range of investment fund products and again demonstrates the understanding the Luxembourg legislator has of the needs of the fund industry to best serve the interests of investors. The RAIF structure allows real estate fund initiators to set up Luxembourg-domiciled funds that are not subject to regulatory approval by
the Luxembourg supervisory authority. This option permits the achievement of a significantly enhanced time-to-market for new fund launches. The RAIF Law will significantly compete with the SIF Law regime in Luxembourg in the near future.

**Legal structures**

Real estate funds governed by the 2010 Law, the SIF Law or the RAIF Law may be set up either in corporate form (e.g., SICAV-SCA or SICAF-SA), in contractual form (FCP) or as a limited partnership (SCS or SCSp). A key determining factor in the selection of one of these structures is the tax regime applicable to investors: FCPs and limited partnerships are tax transparent, whereas SOPARFIs, SICAVs and SICAFs are opaque for tax purposes.

**IV TRANSACTIONS**

i **Legal frameworks and deal structures**

**Deal structures**

When two companies are contemplating an M&A transaction, a crucial preliminary consideration is the legal structure that the transaction should adopt. Determining the transaction structure may be challenging as the buyer and target often have competing interests and different perspectives.

Two types of transactions are mainly carried out in Luxembourg:

- **a** the sale of an existing portfolio (asset or share deal). In the past few years, the number of this type of transaction increased considerably as some German funds that had to be liquidated proceeded to sell their existing portfolios; and

- **b** the sale of a project generally through a share deal with a binding engagement on the developer to build a specific office or retail building for first-class tenants for at least 75 per cent of the surface area.

When transferring real estate in an asset deal, one company will sell directly the property or real estate assets to another company, while in a share deal, the shares of the company owning the property or real estate assets are sold. Both structures are used, but we have noticed that the majority of real estate transactions in Luxembourg are generally carried out through a share deal as the target company that holds the building carries forward its losses and the purchaser avoids registration duty. However, if the purchaser has adopted the form of a SIF and the targeted building generates profit (rents), an asset deal could be deemed more suitable and interesting, as the SIF is exempt from corporate income tax and net worth tax.

**Normal process to acquire a property or a real estate project in Luxembourg**

Real estate transactions usually begin with negotiations performed under a confidentiality and exclusivity agreement. In a first step, they are materialised either with a letter of intent or head of terms to be countersigned by the seller (binding or not and with an exclusivity clause or not until the execution of a share purchase agreement). After having executed the letter of intent, the buyer performs several due diligence processes to determine, identify, assess and limit the risks associated with the acquisition of the real estate assets (legal, administrative and tax, financial audit review, as well as environmental and technical due diligence checks). If the outcome of the due diligence process is not positive (e.g., lack of due authorisations), it may be viewed as a deal-breaker item. Further to the findings of the due diligence process,
a share purchase agreement (SPA) should be drafted to secure the sale. The content thereof is subject to the outcome of the due diligence process and depends on the tax and financial structure of the contemplated transaction. The SPA will be subject to the law of contract in general and the specific rules applicable to sales. As soon as there is mutual consent between seller and purchaser as to the specific asset and the price, a sale agreement is thus concluded even if the asset does not yet exist. It is, however, important to be prudent with regards to the preliminary agreements or binding letters, as these could be viewed by the Luxembourg courts as a binding sale and purchase agreement between the parties.

**Asset deal**

In an asset deal, the buyer purchases only the real estate assets – and assumes only those liabilities – that are specifically specified in the purchase agreement. In this case, the purchaser will generally only inherit those liabilities that it specifically assumes pursuant to the terms of the asset purchase agreement. Some liabilities, such as environmental liabilities, may follow the related assets without a specific assumption in the asset purchase agreement. Where the purchaser is reluctant to acquire certain liabilities of the target company, the purchaser will generally prefer an asset deal. Therefore, the risks and potential liabilities assumed as a result of the acquisition are, in principle, limited to the acquired assets and liabilities. When acquiring real assets through the acquisition of shares of the company that owns the real estate assets, all underlying assets and liabilities are (indirectly) transferred as well.

From a legal point of view, the acquisition of real estate through an asset deal is most often carried out in two distinct phases: (1) a private agreement between parties, and (2) a notarial deed.

**Private agreement**

The private agreement may be constituted by a number of legal mechanisms such as an offer letter, an undertaking to sell or, most often, by a preliminary sale and purchase agreement. Parties are free to negotiate the terms and conditions of such agreements, in any language, and no standard forms are imposed. The effect of preliminary sale and purchase agreements is to bind the parties, and the transfer of ownership documented in such contracts is perfectly valid. However, these agreements are not enforceable against third parties; for them to become enforceable against third parties, a notarial deed is required.

**Notarial deed**

To have the transfer of ownership registered and to confer rights against third parties, the transfer of title needs to be recorded at the mortgage register. The registered deed will take the form of an authentic deed with respect to its date and content and is valid between parties and fully enforceable against third parties. The signing of this public notarial deed will include the release of the securities granted on the assets guaranteed by the seller, as well as the warranty against defects or latent defects and any pollution.

**Share deal**

Instead of the direct acquisition of real estate, quite often special purpose vehicles are set up for tax reasons, whereby the company holding the real estate can be acquired or sold. The purchaser will acquire the shares of the target company and will therefore indirectly take ownership of all of the target company’s assets.
ii Acquisition agreement terms

Asset deal

Particular attention must be paid to the following clauses:

a release of mortgages;
b any termination provisions linked to the vendor’s privilege (should the amount not be fully paid at the signing date);
c contractual limitation of the warranty against eviction and any hidden defects;
d warranty on the surface area and on the lease agreements signed;
e warranty that the building has obtained all the administrative authorisations; and
f warranty that no pre-emption rights in favour of third parties nor risk of nullity of the sale exists.

As the Luxembourg Civil Code provides that a true possessor shall acquire an ownership title through simple occupancy without any interruption during 30 years, a purchaser should request a public notary to verify the title over this period and to have the seller warrant the ownership.

Share deal

The SPA generally contains the most common boilerplate clauses set out in this kind of agreement, and in particular:

a share purchase price and payment conditions (several forms of purchase price adjustments can be considered);
b conditions precedent (reimbursement of loans, acquisition of a plot of land, obtaining of building permits, etc.);
c the absence of material adverse change between the signing and the closing;
d the process until completion (information obligations of the seller towards the purchaser and, to a certain extent, veto power of the purchaser on major issues regarding construction, handing-over and letting);
e conditions subsequent (such as authorisation to be obtained, follow-up for the final acceptance of the project and fine tuning re daily operating of the building);
f representations and warranties of the buyer and the seller;
g arbitration clause for accounting and construction matters;
h terms of the prescription of claims between 12 and 24 months after the closing of the transaction; and
i provisions, such as insurance, to limit the liability and exclude any claims for facts disclosed before the signing or for those claims for which the purchaser can seek indemnities against third parties.

Regarding the insurance, it should be noted that the parties focus more and more on warranty insurances, particularly in distressed M&A situations.

Last but not least, by application of the general principles of Luxembourg civil law, the essence of a share transfer includes the transfer of title to the shares. As a result, the transfer of shares includes the transfer of title to the shares and assumes that the seller has a valid title. However, share purchase agreements under Luxembourg law typically provide for very strict seller’s warranties and indemnities explicitly relating to the seller’s title to the shares.
Financing considerations

Depending on their legal form, SOPARFIs, SIFs and UCIs Part II may be financed through a variety of equity, debt and hybrid instruments (including (convertible) preferred equity certificates – i.e., CPECs and PECs) for these transactions. The acquisition of real estate assets or shares is also generally made through financing from a bank. Transactions are typically structured with a combination of equity and senior bank debt. For projects that are sold in two steps (signing and closing), the future purchaser may replace the banking loans with a mezzanine loan. Luxembourg regulations provide for a wide range of tools to secure first the financing of construction works and second the acquisition costs (i.e., mortgage, pledge over the shares or bank accounts or receivables, assignment of receivables, assignments of rental income or assignment of VAT claim and a joint and several guarantee).

Tax considerations

Generality

As a general rule, income derived from real estate is taxed in the country of location of the real estate assets. In contrast, profits from the sale of shares in a real estate asset held through a foreign company are taxed in the country of residence of the seller, according to the ordinary rules of double tax treaties (to be checked on a case-by-case basis).

Asset deal

Following the general situs principle applicable, income from the sale of real estate is taxed in the country where the real estate is located (with some exceptions for some double tax treaties).

Registration duties are applicable to transactions triggering the transfer of real estate located in Luxembourg. The registration duties are assessed on the higher of the purchase price and the fair market value.

Pursuant to Article 44, Section 1(f) of the Luxembourg VAT law, transfers of real estate are exempt from VAT; as a result no VAT is due when a transfer takes place and, accordingly, no input-VAT deduction is granted. There are two main exceptions to this: the transfer of ownership of a property before construction is started is always subject to VAT, and other transfers of property are subject to VAT if a VAT option form is filed with the VAT authorities. The advantage of this second exception is that the seller has the right to deduct its input VAT on overheads and investment costs.

Share deal

The disposal of the shares of a special purpose vehicle is opaque for registration tax purposes and is not subject to any Luxembourg registration tax or stamp duty, if the disposal is not recorded in a Luxembourg notarial deed. If the share purchase agreement is voluntarily registered, a fixed registration of €12 would apply.

CORPORATE REAL ESTATE

The 2006 boom in M&A was fuelled by increasing liquidity and the willingness of banks to finance acquisitions – and private equity funds played a major role. The pace of M&A activity shows no signs of slowing down and intense competition in the market has led buyers to seek new ways to increase third-party leverage and reduce financing costs. A key method
is the ‘opco/propco’ structure. Luxembourg companies in local and international deals have also followed this trend and in some transactions, they own real estate assets in property companies separated from the operating companies. This structure is also applicable to some international deals, in which Luxembourg is involved as a hub.

VI OUTLOOK

The market for real estate investment vehicles in Luxembourg is constantly developing to provide investors with flexible and innovative real estate investment products. The growth in the number of real estate investment vehicles set up in Luxembourg has outpaced the European average and makes Luxembourg one of the best choices for real estate funds. Luxembourg remains the leading European domicile for vehicles investing in international real estate and this position will increase in the coming years as a result of Brexit. Following Brexit, funds established in the United Kingdom will automatically become ‘third-country’ funds and UK-based fund managers will become third-country managers, for the purposes of the AIFMD.

Consequently, the United Kingdom will lose its European passport for cross-border distribution of investments funds. London City operators would have to move parts of their services to financial centres. Luxembourg could have a good hand in this game, as it specialises in investment funds. Many funds from the United Kingdom already have a subsidiary in Luxembourg, where funds are conceived and registered before they are managed elsewhere, primarily in the City of London. Luxembourg will reinforce this subsidiary position and become the entry point to the European market.
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I OVERVIEW OF THE MARKET

In 2018, Peru’s economy rebounded to 4 per cent, especially in the fourth quarter, due to an increase in public investment in October. In addition, a strong recovery in the fishery sector between November and December and an improvement in performance in the mining sector led to the GDP increase.

The Peruvian Ministry of Economy noted that the recovery of investment and fiscal consolidation were primary drivers for the increase in GDP. Peru achieved the highest growth rates for public and private investments since 2013. This along with the reduction in fiscal deficit and an increase in the recovery of fiscal revenues since 2015 led to the strong rebound of Peru’s economy in 2018.

The World Bank estimates GDP will reach 3.8 per cent in 2019. According to the Peruvian Ministry of Economy, continued public and private investment will continue to support GDP growth in the following years, especially in the mining sector.

Furthermore, the real estate sector has maintained its strength, in all segments, including commercial, offices and housing. Recent government measures have been implemented to provide additional support for social programmes, such as Techo Propio and Fondo MiVivienda, which promote formal (i.e., legally registered) housing by subsidising its acquisition in the lower-income socio-economic groups. Also, the government has issued regulations to allow for the formation and operation of real estate investment trusts (REITs).
i  Real estate – formal sector

Apartment sales in Lima increased in 2018, with an estimate of more than 13,000 units being sold. However, this number is still far from the levels reached in 2011 and 2012, during the years of the real estate boom.8

The number of apartments sold is expected to continue to increase in 2019, reaching an estimated 16,500–17,000 units.9 This increase is driven by the population’s improved spending power, which helps families to secure mortgage loans.

With respect to the prime office market (A and A+), the number of units continued to increase in 2018. However, the vacancy rate decreased in 2018 due to increased business activity and the introduction of co-working spaces, which accounted for 20 per cent of net absorption. Although vacancy rates decreased, the market still has enough supply to continue to place downward pressure on prices.10

ii  Real estate – informal sector

Reducing the housing gap continues to be a major challenge for the Peruvian government. The problem mainly arises from the lack of access to credit among the lower-income socio-economic groups, which is where the demand for housing is highest.

The high prevalence of self-construction has aggravated the problem. Individuals with no access to the credit system often find a solution to their housing problems through self-construction or informal housing, which in most cases does not provide access to adequate habitability conditions or public utilities such as water and drainage systems. According to recent information from the Peruvian Real Estate Developers Association, approximately 18,000 units of formal housing are being built every year, whereas the number of informal buildings is reaching 30,000 a year.11

Semi-formal developers increase this problem. Often companies do not provide appropriate guarantees to ensure the culmination of a real estate project, resulting in serious infringements and frauds. To mitigate this problem, the government has created a central agency to register property developers and provide accurate information to individuals about formal companies in the real estate market. However, based on public information, to date, there are approximately 8,000 informal real estate developers in our country.12

According to public information disclosed by the private pension fund management companies, individuals are willing to use 25 per cent of their pension funds, mainly to repay existing mortgage debt but not to acquire new real estate property.13 Nonetheless, according to the Peruvian Bank Association mortgage portfolio registers its highest growth rate since October 2015.14

To address the problematic housing issue, the government has been running two public housing support programmes aimed at securing financing from the banking system: Techo Propio provides financing to families with lower income (approximately less than US$636 per

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month)\textsuperscript{15} to help them acquire, build or fix an existing home; and Fondo Mivivienda, which provides loans (between US$19,000 to US$128,000)\textsuperscript{16} to lower-middle and middle-income families to help acquire, build or improve an existing home which can be repaid in five to 20 years. This program also offers the possibility of accessing the Good Payer Subsidy (Bono de Buen Pagador) a non-reimbursable economic aid (of a maximum of approximately US$5,470)\textsuperscript{17} granted to persons that acquire a house through the Fondo MiVivienda which enables them to use it towards their down payment.

II RECENT MARKET ACTIVITY

i Public real estate investment fund transactions

Traditionally, the formal sector has been dominated by joint-stock corporations, however, since the mid-2000s, public and private real estate investment funds have begun their incursion into the real estate market.

Also, since 2015, new legislation on two types of public REITs, has been introduced in the market to promote real estate investments. We refer to the FIRBI (real estate investment fund) and the real estate rent securitisation trust, known as the FIBRA (Fideicomiso de Infraestructura en Bienes Raíces), both of which have been widely influenced by the Mexican FIBRA model.

Between 2016 and 2018 the first REITs (through FIRBIs) were registered before the Superintendence of the Securities Market (SMV). However, due to the gaps in the existing regulation, they did not have a major impact in the Peruvian real estate market.

However, since 2018, due to governmental promotion, alongside the modification of the REIT’s regulation, the private sector has increased its interest on FIRBIs and FIBRAs and the number of FIRBIs has increased significantly. ‘F Rentas Inmobiliarias – FIRBI’, ‘Metroport – FIRBI’, ‘Faro I – FIRBI’, ‘AC Capitales Renta – FIRBI’ and ‘SURA Asset Management II – FIRBI’ are some of the new vehicles that have entered the market. The most recent was created with an approved capital of US$1 billion, which makes it the biggest REIT in the Peruvian market as of this date.

Furthermore, on August 2018, the first FIBRA, ‘FIBRA Prime’, was registered before the SMV, with an approved capital of US$5 billion. The first IPO of such FIBRA was launched on December 2018, raising an amount of US$22.5 million. According to public information, FIBRA Prime is about to launch a second IPO during the first half of 2019, for an additional amount of US$30 million approximately.

In addition, the next release of an international FIBRA, FIBRA The Latam REIT, has been announced and is on its way to registration before the SMV. The particularity of this FIBRA is that it plans to make investments in real estate located in different Latin American countries for an amount of up to US$7.5 billion and 35.6 per cent of this amount is estimated to be invested in Peru.


ii M&A and other transactions
A successful example of an M&A transaction in the real estate and hotel sector is the acquisition in 2018 of the Atton Hotels by the international hotel chain AccorHotels and the Chilean Group, Algeciras. Through this transaction, which valued the Atton Hotels at US$365 million, AccorHotels and Algeciras will operate 11 hotels and continue with the development and construction of three new projects, located in Chile, Peru, Colombia and Florida, United States.

III REAL ESTATE COMPANIES AND FIRMS
i Traditional real estate companies
The main real estate investments and activities are developed by traditional corporations. Peru does not have specific regulation for corporations dedicated to the real estate market.

The Peruvian Corporations Law recognises three types of joint-stock corporation: a general type of joint-stock corporation (SA) and two other special types of joint-stock corporations, the SAC, which is a closed joint-stock corporation, and the SAA, which is a public joint-stock corporation.

In addition to the above-mentioned forms of joint-stock corporations, the Peruvian Corporations Law also regulates other forms of companies and partnerships, including the limited liability partnership, which is very similar to the SAC and is also often used.

All the above corporations and companies confer limited liability on their shareholders, who will only be liable up to the amount of their capital contributions. Also, all the above forms of corporations and companies receive the same tax treatment.

ii Public and private real estate investment funds
The Peruvian market has evolved in recent years because of the sustained increase in the number of public and private real estate investment funds (the Investment Funds). The Investment Funds are independent asset pools comprising of contributions made by individuals and legal entities for investments in the acquisition and development of projects that generate financial returns through the sale or rent of real estate units.

Typically, most of these investments were focused on the residential sector (housing); however, the demand for commercial premises has been growing rapidly over the past years because of the opening of shopping malls, strip malls, and office buildings, as well as the launching of industrial centres.

The Investment Funds are managed on behalf of and at the risk of the fund’s members by private equity companies known as investment fund management companies, or SAFIs, whose sole purpose is to manage one or more investment funds.

In addition, the Investment Funds are monitored by an oversight committee, which oversees the SAFI’s compliance with the law, membership regulations and placement terms, ensuring that the information provided to the fund’s members is accurate and timely, supervising the implementation of changes required following any objections made by the external auditors, and that the general shareholders’ meeting is duly held to report on the management of the fund or when necessary.

Furthermore, SAFIs are monitored by an investment committee, the main duties of which are, among other things, to follow up on the fund’s assets, determining their value.
and the method to be used for evaluating them, and identifying and analysing different
investment opportunities (taking into consideration the fund’s policies and guidelines), as
well as making investment decisions for the fund when required.

iii Peruvian REITs – FIBRA and FIRBI

Background

REITs are not unheard of in the Peruvian Market. They have been around since the
mid-2000s, when public and private investment funds began their incursion into the real
estate market through the acquisition of land and property developments. However, until
2015, the expansion of these investment ventures was very limited, mainly due to the lack of
specific regulation tailored to the specific characteristics of REITs.

On 24 November 2016, the Peruvian government enacted specific legislation related
to REITs for the first time. This regulation created two new types of REITs: (1) the real
estate rent investment fund (FIRBI) and (2) the real estate rent securitisation trust (FIBRA).
The aforementioned legislation has opened a path for REITs, accommodating these kinds of
investments.

When designing the mentioned REITs, the impressive results of the Mexican FIBRA
since its creation in 2011 caught the attention of the Peruvian government. In fact, it is
estimated that the Mexican FIBRA has yielded a revenue of 150 per cent during periods
where the performance of the Mexican stock market did not exceed 50 per cent. Moreover,
since its creation the Mexican real estate market has experienced a steady increase, as well as
the incorporation of a number of new REITs.

The Peruvian model: FIRBI and FIBRA

The American REIT model, together with the Mexican experience, helped design the
Peruvian FIRBI and FIBRA; which is why foreign investors may find these investment
vehicles very familiar. The most important characteristics shared by the FIRBI and FIBRA
with the aforementioned models are the following:

a The funds raised from the investors must be allocated exclusively to the acquisition or
construction of income-producing real estate (e.g., industrial buildings, commercial
offices, hotels, residential developments, among other real estate assets), so that the
properties owned by the trust may be allocated exclusively to the generation of income
from its lease.

b The beneficiaries of these investment vehicles (in the case of FIRBI and FIBRA, the
holders of the instruments are called Participation Certificates) are entitled to the
revenues yielded from the fund through its two main sources: (1) the income derived
from the lease of the properties, and, (2) the appreciation of said properties since its
acquisition until it is sold.

c They are meant to be attractive to investors, by allowing them access to certain tax
benefits through these vehicles (e.g., lower income tax rates compared to those applicable
for corporate taxation). In turn, those tax benefits create efficiencies in the real estate
market, since through them, almost anyone can invest in portfolios comprised of real
estate assets, just as they would in other industries.

Although there are similarities with the American REITs, the Peruvian models of the FIRBI
and the FIBRA have the following distinctive features:
Unlike the American REIT, FIRBIs and FIBRAs do not have stockholders, but rather beneficiaries. They are not considered a legal entity that may be incorporated as a joint-stock corporation and, therefore, cannot make their own investment decisions. The FIRBIs and FIBRAs require another entity which makes those decisions on its behalf. In the case of FIBRAs, the entity in charge of the trust's management is a securitisation entity, while the FIRBIs are managed by a fund management entity.

Participation in the FIRBI and FIBRA must be placed through a public primary offering with at least 10 unrelated investors, and at least 70 per cent of the funds raised by these vehicles must be used in the acquisition or construction of income-producing real estate.

They must distribute most of their net income (i.e., at least 95 per cent of its profits according the current regulation) among their beneficiaries.

For taxation purposes these vehicles are considered transparent, which means investors who take part in them will be taxed at an identical rate as if they were to lease their own real estate properties as individuals. This characteristic is of particular relevance when compared with the general tax rate for corporations, since the income tax rate that a corporation is taxed at for the lease of real estate is significantly higher (29.5 per cent) than that of an individual (or, in this case, a FIRBI or FIBRA); which amounts only to 5 per cent. Another example of this transparency may be found regarding the real estate transfer tax, which can be deferred to either the moment in which the income-producing real estate is transferred by the FIRBI to a third party, or, to the moment when the investor who contributed the income-producing real estate transfers any of his Participation Certificates. However, we must note that this last consideration regarding the real estate transfer tax is only applicable to FIRBIs.

It is important to highlight that, although FIBRAs and FIRBIs are quite similar in nature, there are some relevant differences between the two investment vehicles and they are subject to different regulations. FIRBIs are created under the rules of the Investment Fund Regulation, while FIBRAs are created under the Secularisation Process Regulation. This has practical consequences, in particular, in the way they are organised and how these vehicles are governed. As noted, the main difference between both vehicles is in the entity authorised to manage them; a securitisation entity in the case of FIBRAs and a fund management entity in the case of FIRBIs. In terms of operation costs, FIRBIs may be less expensive than FIBRAs, due to the participation costs of a securitisation entity.
Recent changes regarding FIBRA’s regulation

Although the structures of FIBRA and FIRBI were created in 2016, they lacked comprehensive regulations regarding its organisation and governmental bodies. At the time of writing, FIRBIs still lack such regulation. However, for the case of FIBRAs this is no longer the case, since on 27 February 2019, the Peruvian Security Exchange Commission modified the regulation for asset-backed securitisation through which FIBRA and FIRBI were created to include more extensive rules regarding FIBRAs.

One of the most interesting changes introduced by this bill is the possibility for FIBRAs to make international invitations for the subscription of participation certificates, which opens the possibility for foreign investors to participate in the peruvian real estate market through FIBRAs. However, this is only possible if the placement of the participation certificates is made through a public primary offering within the Peruvian territory, and, as long the intermediary agent is supervised by a similar entity as the SMV.

Other significant changes with relevant consequences for investors are the following:

a. The possibility for FIBRAs to acquire future real estate assets, such as buildings that are still under construction. The only consideration regarding the acquisition of these kind of assets, which certainly gives more flexibility to the investment decisions that can be made, is that the land where the new structure is to be built must be already registered at the time of the acquisition.

b. A list of circumstances that may result in the FIBRA becoming a standard securitisation trust and, therefore, losing all tax benefits granted by the Peruvian government to FIBRAs, such as being subject to the income tax rate applicable for corporations, which as noted earlier, is significantly higher. Among those circumstances, the most relevant are the situations where the FIBRA (i) fails to allocate 70 per cent of its assets to income-producing real estate; or (ii) sells the real estate assets within the first four years since acquisition (i.e., in the case of real estate assets acquired for its construction, the term will begin when the construction is finished and it will only be possible to sell them once the construction is finished and the four year term has elapsed).

In December 2018, the first IPO for a FIBRA was launched under the name of ‘FIBRA Prime’. Over US$22.5 million was raised, partially from institutional investors (30 per cent), but mainly from the general public (70 per cent). FIBRA Prime administrators expect to raise up to US$5 billion in the next three years. This is certainly the first of many new investments that are expected to launch officially in 2019. Among them, probably the most important is the FIBRA called The Latam REIT, which has been officially announced and is expected to raise up to US$7.5 billion. This vehicle will include real estate properties located in Peru (35 per cent), Mexico (22 per cent), Colombia (22 per cent), and other Latin American countries.

We see the entrance of FIBRA and FIRBIs as a great chance to take the Peruvian real estate market to the next level and foresee considerable amounts of new investment flowing towards it.

IV TRANSACTIONS

i. Real estate acquisition agreements

The most common type of transaction for the acquisition of real estate properties in Peru is the asset sale and purchase contract, whether related to an existing property or a future asset.
The main reason for the buyer to proceed with the direct acquisition of a real estate property is to avoid assuming the liabilities of the existing legal entity holding the property. Prior to executing a sale and purchase contract, a complete legal and technical due diligence review of the property is highly recommended.

The legal due diligence review is focused on the property title (to confirm the areas and boundaries of the property, verify the ownership status and the existence of any mortgages, liens or encumbrances, the registration of any limitation for the sale of the property, and the registered constructions), the zoning and urban parameters, the existence of outstanding payments for property and municipal taxes, and any existing licences or permits, among other relevant matters.

On the other hand, the technical due diligence review will seek to verify the areas of the property, the structural shell and the quality of the soil, as well as the functionality of the technical installations (water supply, drainage, power and electricity systems, air conditioning, elevators, exterior lighting, heating systems and others). Also, a physical review of boundaries and environmental conditions may be useful in many cases.

It is also common to execute a future asset sale contract when the real estate property is still in the project or construction phase. These contracts are definitive agreements conditional on the effective existence of the property (usually when the property is registered as an independent unit in the real estate public register).

A share purchase agreement is less common, as it is used when the seller wishes to sell its entire real estate business, and the buyer is interested in acquiring an ongoing enterprise. One of the main reasons for the buyer to acquire the business is to receive a fixed rental income arising from contracts executed by the target company (lease contracts or any other type of onerous contract that grants use rights over the property to third parties). Spin-offs and mergers are also sometimes used to trade real estate.

In this case, the scope of the due diligence review of the target company will involve several matters focusing on identifying the liabilities arising from labour, tax, and contractual matters, as well as judicial proceedings. In addition, the buyer will need to obtain detailed information from the seller with respect to its assets, finances and business operations.

Since the information collected during the due diligence process is confidential, it is standard to execute a confidentiality or non-disclosure agreement before obtaining access to this information. It is also standard practice in this type of transaction for a letter of intent to be signed, agreeing on the main terms of the transaction and specifying that the execution of the transaction is subject to the satisfactory results of the due diligence process.
Financing considerations

There are no special regulatory considerations regarding the financing of real estate acquisitions in Peru. Real estate operations are typically financed from a combination of equity and debt. The most common types of structures used to secure lending obligations are mortgages, share pledges, and warranty trusts.

Under Peruvian legislation, a mortgage works as a lien over a specific real estate property. To be enforceable against third parties, it must be formalised through a public deed and must be registered in the real estate public register.

On the other hand, share pledge agreements allow companies to use their shares as collateral to avail themselves of a loan. Pursuant to Peruvian legislation, for the agreement to be effective against third parties it must be formalised through a public deed and registered in the public Moveable Property Contracts Register and in the company’s share ledger.

Finally, warranty trusts have been used more frequently over the past few years as security for financings. Warranty trusts can be used in relation to either real estate property or moveable goods, and they also must be formalised through a public deed. If the trust is created using real estate property, it must be registered in the real estate public register, and in the case of moveable goods, the registration must be made with the Moveable Property Contracts Register.

With the real estate market being boosted by the entry of investment funds, it is expected that the public market will be targeted as a source of funds for the financing of real estate acquisitions or projects. However, the traditional mechanisms of financing remain those mentioned above.

Tax regime on real estate transactions

Buying real estate

The acquisition of real estate property is subject to a real estate transfer tax at a rate of 3 per cent of the transfer value of the property. An amount of 10 UIT (a unit of monetary measurement, updated every year by the government to handle payments to be made to the government, such as taxes and fines) may be deducted from the transfer value to determine the tax base. The UIT for 2019 is 4,200 Peruvian soles (approximately US$1,273). Note that the taxpayer of the real estate transfer tax would be exclusively the purchaser of the property.

In the case of the first sale of a new real estate property by the constructor (a real estate company), real estate transfer tax would only apply to the value of the land. In addition, the transaction will be subject to value added tax (VAT) at a rate of 18 per cent, applicable to 50 per cent of the transfer value (i.e., an effective rate of 9 per cent).

Selling real estate

In general terms, the transfer of real estate property located in Peruvian territory is subject to income tax. Income tax must be paid on capital gains derived from any transfer (e.g., sale or capital contribution in kind) of real estate property qualifying as taxable income.
The capital gains are determined as the difference between the transfer price (which must meet market value standards) and the tax base the seller has in the corresponding property. The tax rate applicable to the capital gain depends on the seller’s status. Currently, the following rates may apply:

- **a** Peruvian domiciled and non-domiciled individuals must pay 5 per cent tax on the gross income. However, non-domiciled individuals may request to be taxed only on the difference between the initial purchase price and the selling price through an administrative procedure before the tax authority, known as ‘reimbursement of invested capital’.

- **b** Peruvian domiciled entities must pay 29.5 per cent tax on their net income, and non-Peruvian entities will be subject to 30 per cent tax on the gross income. Notwithstanding, the non-Peruvian entity must also follow the ‘reimbursement of invested capital’ procedure before the tax authority.

For transfers of real estate property through corporate reorganisations (e.g., mergers, spin-offs, simple reorganisations), it is important to highlight that the income tax and VAT regulations establish special tax regimes, so assets can be transferred without generating tax effects. Nevertheless, the acquisition of real estate property between Peruvian entities through a corporate reorganisation would still be subject to real estate transfer tax, as previously explained.

**Renting real estate**

Peruvian domiciled and non-domiciled individuals who obtain an income from the lease of a real estate property must pay 5 per cent on the rental income.

Peruvian domiciled entities that lease a real estate property in Peru must pay 29.5 per cent tax on the rental income after applying the tax deductions permitted by the applicable laws, and non-Peruvian entities that lease a real estate property in Peru will be subject to 30 per cent tax on rental income.

**Holding real estate**

Real estate property owners are subject to property tax and to municipal taxes, the rates for which are calculated based on the value of the property and the area where the property is located.
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, has maintained its reputation as the most important real estate market in Central and Eastern Europe (CEE). Moreover, it has been reported that 2018 was a record year in terms of investments for the real estate market in Poland. In 2018, the total volume of investment transactions reached a record level of €7.2 billion compared to €5.1 billion a year earlier. This amount comprised more than 100 transactions covering a total of 200 properties, which also represents an increase compared to 2017. Thus, Poland maintained its leading position among the six CEE countries, this time with a market value record high of 50 per cent (compared to 19 per cent generated by the Czech Republic and 14 per cent by Hungary). That increase was noticeable in all segments of the real estate market. There was an overall improvement in Poland’s economic situation (GDP growth by 5.1 per cent, increase in private consumption by 4.5 per cent and in public investments by 10 per cent, as well as a very low unemployment rate of 5.8 per cent).

Although initial market analyses conducted in 2019 show a 27 per cent drop in the value of transactions compared to the average value of Q1 transactions in 2016–2018, we are quite optimistic as to the market’s future. This applies in particular to Warsaw, where the demand for office space is the highest countrywide and continues to grow, and also to the steadily growing real estate markets in regional cities such as Wroclaw, Crakow, Poznan, Gdansk and Lublin. 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, for the time being, too strong competitors for Polish private equity investors, whose activities remain marginal given the size of the Polish market. The lack of legal regulations allowing the creation of REITs does not encourage Polish investors. So far, 70 per cent of the capital invested on the Polish market has come from US, South African, German and UK investors. Investors located in South East Asia (including Singapore, Malaysia and the Philippines) have also become more active in the Polish market.

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 the risk and link the final price of a company to enterprise income at the time of closing. Similarly, a fall can be seen in the liability level of sellers for a breach of representations and

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1 Izabela Zielińska-Barłożek, Łukasz Szegda, Michał Nowacki and Michał Wons are partners, and Maciej Szewczyk, Radosław Wasiak and Marcin Pietkiewicz are senior associates at Wardyński & Partners.
warranties, which is caused, inter alia, by market security and predictability as well as due to the fact that most of the transactions between investment funds is subject to W&I insurance and/or title insurance.

To sum up, Poland is the first choice for private equity funds interested in investing in CEE. 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.

Nevertheless, in the near future the real estate market in Poland may face threats that result from an interest rate increase expected in 2019 (limiting the availability of loans), as well as new legal regulations that may affect individual market segments. An example of such regulations is the gradually introduced ban on Sunday trading that has already affected the profitability of investments in commercial real estate and that will be extended in 2020 to include all Sundays. Moreover, we can expect in the near future major investments of the State Treasury in the housing sector, as the government is getting ready to launch a subsidised affordable-housing program. Involvement of public funds may constitute competition for developers and entities investing in residential real estate for rent. On the other hand, new regulations, friendly to private developers investing on the housing market, have also been passed. These regulations introduce a number of exemptions from the general regulations on housing investments and, consequently, should fasten the process of collecting various permits and reclassifying land to allow housing developments thereon. Further, current restrictive regulations on trading farmland are to be liberalised, allowing acquisition of up to one hectare of farmland and of shares in companies holding up to five hectares of farmland without permission of the public authorities or without the involvement of pre-emption rights. Also, amendments to the Construction Law as well as a regulation on local zoning are expected in the near future. The aim of these changes is to facilitate the process of obtaining investment permits, limit the number of requirements that investors must meet, and open new lands to property investments.

II RECENT MARKET ACTIVITY

Poland still lacks relevant legal regulations allowing entities in the form of REITs to operate on the market. Although some initiatives have been taken, the legislative process is still frozen and there are no signs of change.

The year 2018 abounded in numerous real estate transactions in all its segments. The most active investors were Griffin Real Estate, Mapletree, Globalworth, EPP, Revetas/Goldman Sachs, Blackstone, Atrium European RE, Employees Provident Fund, European Logistic Investment BV, Madison International, NIAM, ISOC, Generali and GLL Real Estate Partners.

The largest deal on the retail market, finalised in 2018, was the acquisition by Chariot Top Group BV, managed by Griffin Real Estate, of a portfolio of 28 properties consisting of 9 ‘M1’ branded shopping centres, four amusement parks, 12 supermarkets and three construction DIY markets. The transaction value amounted to €1 billion.  

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Another major transaction finalised on the retail market in 2018 was the acquisition of a complex of three department stores (Wars, Sawa and Junior) located in Warsaw city centre. The transaction was concluded between Atrium European Real Estate (the buyer) and PFCEE – a fund managed by CBRE Global Investors. The value of this transaction was €300 million.8

In the office-space market segment, Revetes and funds managed by Goldman Sachs Asset Management acquired from TPG Real Estate the entire Tri Grant portfolio, i.e. a total of approximately 173,000 square metres of office space. This transaction included the sale of Bonarka Business Park in Cracow and Silesia Tower I in Katowice, as well as projects under construction such as the B4B H in Cracow. The estimated value of the transaction amounted to €450 million.9

In addition to the above, other significant transactions involving office space were concluded with respect to properties located in Warsaw. Madison International Real Estate Liquidity Fund VI LP acquired from Ghelamco a 50 per cent share in Warsaw Spire A (an office tower 220 metres tall) for approximately €175 million.10 A similar transaction has already taken place in 2017 when the other 50 per cent share in the Warsaw Spire A tower with an area of 64,500 square metres was sold. Both transactions confirmed the estimated value of this investment at €350 million.

The sale of two office buildings in Gdańsk Business Center in Warsaw (53,000 square metres) was finalised between HB Revis and Savills Investment Management (acting on behalf of a global pension fund) at over €200 million.11 CPI Property acquired from Peakside Capital the Atrium Centrum and Atrium Plaza office buildings, holding approximately 32,000 square metres of office space.12

Globalworth Poland was very active on the market. It bought Warta Tower for €55 million from Kulczyk Real Estate Holding13 and purchased Spektrum Tower from Europa Capital (approximately 29,500 square metres of office space), also located in Warsaw.14 Globalworth Poland was also active outside Warsaw. It bought a complex of five office buildings located in Quattro Business Park in Cracow from Starwood Capital Group for €139 million.

As to the warehouse segment of the real estate market, it should be noted that the largest single transaction on that segment took place in 2018. European Logistic Investment BV managed by Griffin Real Estate acquired a portfolio of nine logistics parks (including

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9 http://eurobuildcee.com/?page=news&id=33995
locations in Warsaw, Lodz and Cracow), constructed by Panattoni Europe. The entire gross lease area of these centres amounts to 300,000 square metres. The estimated value of the transaction is €200 million.15

When talking about logistics parks, besides the aforementioned purchase transaction, we should bring up significant lease transactions concluded in 2018, among them leases of BTS projects for Amazon (167,000 square metres in three different locations), Leroy Merlin (124,000 square metres near Lodz) and Zalando (121,000 square metres in Olsztyn).16

The new trend can also be observed on the residential real estate market, which so far has been concentrated on selling apartments to individuals. Starting with 2018, there has been a number of portfolio transactions also in this segment. For example, the largest transaction on the residential market, finalised already in 2019, was the one-off sale of an entire development of 175 apartments to a financial investor.17

III REAL ESTATE COMPANIES AND FIRMS

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

Unfortunately, despite market expectations in 2018, regulations governing REITs were still not adopted.

Work is under way on new regulations in this area. However, in relation to original assumptions, the concept of classic REITs benefitting from tax preferences is to be significantly curtailed. REITs are to be replaced by companies that invest in rentals of real estate (FINN). Such entities are to take the form of joint-stock companies whose sole business will be to invest in residential properties for rent. Both FINNs and their subsidiaries and shareholders are to benefit from tax allowances on revenues to be generated by these investments. The final shape of the new regulations is not yet known. However, this is certainly not what investors were expecting as there is no rationale for limiting the use of such investment vehicles only to the residential sector. Moreover, we do not expect that even these limited but long-awaited regulations will be adopted in the near future.

ii Real estate PE firms – footprint and structure

The Polish real estate investment fund market is diffuse, 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, including shopping centres, offices and a student hostel chain (Student Depot) in its 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 special purpose vehicles (SPVs) to acquire undeveloped property and sell it after its development (or redevelopment) and when the space is fully leased. It is worth noting that companies such as Griffin, apart from investing their own resources, also frequently provide management services for assets of global investment funds.

16 The Polish Real Estate Guide 2019 Edition Poland – EY.
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 property) 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, as regards transactions directly involving real property, 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 shareholdings in the most popular company type, the limited liability company, while less formalised, notary involvement, however 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 and the market effect of a transaction (including any competition aspects).

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 another right to the 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 the real property, but was entered in the land and mortgage register as its owner at the time of the transfer and there were no other entries or annotations in the register entries that could raise doubts about 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 as indispensable. However, with regard to the very essence of a transaction – that is, effective acquisition of the 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

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18 For example, nationality or country of registered office and, pursuant to a new recent law, occupation, with regard to agricultural land.
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 the right.

In share deals and generally in transactions involving the merger, division or transformation of companies, an 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 the 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 the 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, with one exemption: when a company that is the subject of a transaction owns agricultural properties with an area exceeding five hectares.

Finally, since real estate transactions often do not relate to land alone, but also 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 the 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 reobtained.

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 the conclusion of a final contract that effectively transfers legal title to real estate. However, this does not 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 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 property 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 a 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 the 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 the 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 cases, a state agency has a statutory pre-emption right to the shares. These regulations apply to agricultural properties exceeding an area of one hectare and companies holding more than five hectares of farmland.

The aforesaid legal constraints pertaining to the conditional transfer of real property 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 the 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 interest for 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 the liability mechanics applicable to the 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 Warsaw Stock Exchange 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 coming years because of improved prospects and higher profit margins than those found in western Europe or the United States, 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. It should also be borne in mind that there have been just a few attempted hostile takeovers in Poland so far, and that the majority of them were unsuccessful.
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. 19

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 takeovers. 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 where a company is only planning its initial public offering. Most popular among these measures are restrictions on disposals 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 to, for example, 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 the 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 (in the form of either share capital of shareholder loan), include bank loans, non-banking financing, leasing and bond issuance. Regulatory pressure on banks limit their appetite for more risky assets, thus giving room for alternative sources of financing in this segment. Asset class and investor reputation on the market are key factors for credit committees.

Mezzanine and other junior debt financing sources are also increasingly popular on the market. One example of such recent transactions was a mezzanine financing provided by a US fund in a newly developing asset class on the Polish real estate market – student housing.

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 was expected to create a new promising source of financing in the future, although discussions on a draft law introducing REITs are extensively prolonged and the current draft is widely disappointing for a lot of market players.

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19 2004/25/EC.
As for traditional bank lending, this source of funding is very easily accessible in high volumes, mostly owing to low borrowing costs and solid fundamentals. According to Cushman & Wakefield, the level of bank financing for properties in Poland is stable, averaging approximately 60 per cent of each property's value. 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.

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., the required pre-let level or scope of required sponsor support). Bank financing is widely available not only in the Polish currency, but also in foreign currencies (in particular, the euro).

Banks are also extending the range of assets they are willing to finance. In addition to core segments such as office, retail and industrial, alternative investments, including hotels, apartments for rent, student housing or nursing operators, are increasingly popular.

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 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. 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 for the registration itself.

The financing structure and typical timetable may differ depending on whether a financed transaction is a share or asset deal. In the case of an asset deal, because of the noted prohibition on conditionality of real estate acquisition transactions, escrow accounts are often set up to secure the safe transfer of the purchase price. Funds are released from the escrow once the property is transferred and a mortgage is established for the benefit of the lenders financing a transaction.

**Tax considerations**

Among the different transaction structures outlined above, asset deals have prevailed 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 (in the case of small taxpayers, a 9 per cent income tax may apply).

As for transactional taxes, in the case of an asset deal the parties usually opt for VAT taxation. In such cases, 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. On occasion, tax authorities tend to claim that in the case of a commercial real estate transaction (e.g., shopping centre, office building already leased to tenants), it is more proper to classify the transaction object as a going concern.

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).

To manage tax risks related to a transaction (e.g., the right to opt for VAT or the classification of a transaction object as not constituting a going concern), each party can apply for a tax ruling or both parties can file a joint application for a tax ruling (recommended option).

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.

In 2018, a minimum income tax for taxpayers with commercial property (including shopping malls and office buildings) was introduced and was subject to substantial changes starting from 2019. It applies to all taxpayers who own or jointly own buildings in Poland that are used for chargeable purposes under a lease, tenancy or similar agreement. The tax rate is set at 0.035 per cent per month of the initial tax book value of the real property, but there is a tax free amount of PLN 10 million. The minimum income tax is deductible from CIT. The tax free amount is split between asset-owning company and its asset owning subsidiaries in the proportion reflecting the ratio of the income from the taxpayer’s building to the total income of all the related entities from the building. There is a possibility to apply for the refund of minimum tax that was not deducted if the tax authority identifies no irregularities in the tax liability or loss amounts calculated in the submitted tax return, and in the amount of the tax on revenue from buildings, in particular where the costs of debt financing incurred in connection with the purchase or creation of the building, as well as other revenues and costs, were determined on market terms. In practice, such application substantially increases the risk of tax audit.

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 timing of simultaneous transfers of title of all real property. If there are conditions precedent for closing, it is not possible in some jurisdictions (including Poland) to transfer ownership or perpetual usufruct (a proprietary right close to ownership) to a property on this 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 advisers, notaries 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 a transfer of real property in each jurisdiction are complementary and are governed by the master agreement to the extent possible under the 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 remains optimistic. It may be challenging to improve the record-level results achieved in 2018, but, in terms of the value and volume of transactions, the situation should stabilize at this high level. 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 and the development of transport infrastructure. It also seems that the GDP will continue to grow, of course subject to the global market situation. Most investment funds will likely focus more in the next few years on properties in regional cities (Crakow, Lodz, Poznan and Wroclaw, as well as the Tri-city area or even cities in Poland’s eastern part such as Lublin or Rzeszow), however we do not expect any threat to the position of Warsaw as the main real estate investment market. The Polish market follows global or European tendencies where the volume of real estate transactions increases. A specific segment of the market that will be of special interest in the near future is logistic and warehouse properties, as a result high demand for warehouses (owing to the dynamic growth of e-commerce). We also expect higher investment in the hotel sector, as a number of hotel construction projects has been announced recently.

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The introduction of REITs has been postponed and we are not too optimistic about its final approval by parliament. This may impact and stabilise the current structure of the real estate investment market. Recent years have been dominated by European (particularly German) funds. Now there is an increasing presence of capital from more distant countries such as the United States, South Africa, Arab oil-financed economies and Asian investors. 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.
I OVERVIEW OF THE MARKET

Commercial real estate investment in Portugal set a new record in 2018, reaching a historical €3,500 million threshold, representing a 54 per cent increase over 2017 (an already record-breaking 50 per cent increase over 2016). This figure was mostly the result of high-ticket deals involving shopping centres and transactions of several office portfolios.

Retail continued to lead investor preferences, making up for 43 per cent of the total annual investment. In this particular area, Lisbon took the Iberian podium in 2018, accounting for approximately 28 per cent of the total value traded, the average value per operation being circa €193.4 million. This figure represented a smaller number of deals compared to Madrid, but with considerable value, including two transactions of more than €400 million.

Aside from retail, other classes of assets also benefited from investment diversification; the office sector totalled 27 per cent of all investment, and the industrial and logistics sector accounted for a relevant investment volume despite their less robust profile in the national landscape. As a consequence of booming tourist activity, the Portuguese hotel industry had a strong year, with investment around €230 million, including the transaction of the hotel Intercontinental Porto Palácio das Cardosas for the record value of €500,000 per room.

Also marking 2018 was the initial push from national banks to decrease the amount of non-performing loans (NPL) and real estate owned (REO) in their balance sheets so as to abide by European regulations; about 15 portfolios were sold during 2018 for an aggregate value of €7.5 billion, REO transactions being purported to amount to circa €1.3 billion.

A stable political and economic context also contributed to these record figures; according to the Portuguese Central Bank, the Portuguese economy registered a 2.1 per cent increase in 2018, slowing down slightly when compared with the 2017 number, where a 2.8 per cent increase was registered.

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1 João Gonçalo Galvão is a partner at Campos Ferreira, Sá Carneiro & Associados. The author would like to thank António Rocha Mendes, partner and head of tax at the firm, for his contribution to Subsection IV.v on tax considerations.
II RECENT MARKET ACTIVITY

i M&A transactions

The start of 2018 brought the news of the acquisition by Tiekenveen Holding BV (an Auchen Group subsidiary), to the Blackstone Group, of the shopping centre schemes Forum Sintra, Forum Montijo and Sintra Retail Park, totalling 131,462 square metres of gross leasable area (GLA), for a value of €411 million.

Also on sale by Blackstone was Almada Forum, a 230-shop scheme of 82,000 square metres bought by Spanish SOCIMI Merlin Properties in July 2018. This asset had been previously acquired by Blackstone from Commerzbank back in 2015, for a value of approximately €224 million.

In January 2018 Spanish ORES SOCIMI bought a supermarket and stand-alone portfolio (comprising two hypermarkets, two supermarkets and two stores) of 47,424 square metres from Sonae Retail Properties for €86 million.

In addition, investment in assets for urban development also showed a consistent increase in 2018. Regarding the most relevant deals, the spotlight goes to the sale of the city-centre grounds of the old Feira Popular location to Fidelidade Property for €273.9 million (foreseeing construction of a total of 239,264 square metres, mostly for services and residential).

ii Private equity transactions

As part of a sale-and-leaseback transaction, the ‘Mistral portfolio’ comprising 16 high-street retail properties, two of which are located in Lisbon, with 35,000 square metres of GLA was sold in January 2018 by Inditex/Zara España S.A. to Deka Immobilien funds’ Deka-ImmobilienEuropa and to WestInvest InterSelect for a value of €400 million.

Also in January 2018, Axa Investment Managers acquired, on behalf of their clients Dolce Vita Tejo, the second largest shopping centre in Portugal of 80,360 square metres, for €230 million, from the North American Baupost fund (90 per cent) and Eurofund Investments (10 per cent).

In June 2018 National Teixeira Duarte group sold to the Kildare PE fund the Lagos Park office park, comprising 13 office buildings as well as a retail gallery, with an area of 85,000 square metres, for €375 million, in what was the largest deal in the history of the Portuguese office sector.

In July 2018 the Apollo Global Management fund acquired a portfolio of 277 assets, 70 per cent of which are residential, located in Lisbon, Porto and other regions to Fidelidade – Companhia de Seguros, S.A. and Fidelidade – Property Europe, S.A. for a value of €350 million.

In the tourism sector, Deutsche Bank sold to the Carlyle Group and to Explorer Investments the Penha Longa Hotel & Golf Resort for a rumoured value of €100 million.

III REAL ESTATE COMPANIES AND FIRMS

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

In January 2019 the long-awaited Portuguese REIT regime was finally approved pursuant to Decree-Law 19/2019, of 28 January, which came into force on 1 February (with an amendment already being expected to be published and come into force during the third quarter of 2019). This Decree-Law created the real estate investment and management companies (SIGIs) for the purpose of promoting and driving the national real estate market, particularly in the lease sector.
SIGIs can either be newly incorporated entities or result from the conversion of previously existing companies or collective investment entities (OII) under the form of companies. SIGIs are required to take the form of share companies, with or without public subscription, with a minimum share capital of €5 million, which within one year of their incorporation or conversion should be traded in a regulated market or in a multilateral trading system located or operating in Portugal or in another EU or EEA Member State. Of such trade, at least 20 per cent of the share capital of SIGIs should be dispersed between investors holding, individually, no more than 2 per cent of the respective voting rights (the amendment to Decree-Law 19/2019 being expected to set this 20 per cent threshold for the end of the third complete year of trading and raising it to 25 per cent at the end of the fifth year).

The corporate scope of SIGIs should consist of the acquisition of rights over real estate for leasing or other permitted contractual arrangements, including the development of construction or rehabilitation projects. Provided that a number of relevant legal requirements are met, SIGIs may also hold shareholdings in other SIGIs or similar companies located within the EU, as well as participation units in OII or real estate investment funds or companies for residential lease (FIIAH or SIIAH). Rights over real estate and interests in other entities should account for at least 80 per cent of the SIGIs’ total assets, with the value of rights over leased properties or properties subject to other permitted contractual arrangements, amounting to 75 per cent of the total asset’s value.

Although the new SIGIs regime represents the cornerstone of REIT regulations in Portugal, the respective tax regime was not initially clear and the anticipated amendment to Decree-Law 19/2019 should clarify that the OII tax framework shall apply to SIGIs. As SIGIs have not yet had the chance to cause an impact, other than by real estate funds (as detailed in the following subsection), real estate M&A is mostly driven by commercial limited liability companies by shares or quotas, usually qualified as REOCs pursuant to their corporate scope, consisting of the development and management of real estate assets, as well as the sale and purchase of assets for their subsequent resale.

**ii Real estate PE firms – footprint and structure**

Key domestic players in the private equity sector, such as ECS, Explorer, Magnum Capital or Oxy Capital, are primarily enrolled in venture or growth capital. Funds have, however, been set up to conduct investment in the real estate sector, namely in companies with attractive real estate assets for development or tourist operation.

Private equity investment in the real estate sector has therefore been deployed either through private equity or venture capital funds; more traditionally, investment is made through OII in the form of real estate funds or companies. The latter are collective investment schemes similar to funds but structured as share companies with a fixed or variable share capital (respectively named SICAFI or SICAVI) whose assets are held in ownership and managed either by self-management or third-party management. The share capital of OII in the form of companies is represented by nominative shares without nominal value, which are issued and traded as per the rules that govern the participation units of real estate funds.

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2 Although subject to the organisation requirements and duties applicable to managing entities, including with regard to the managed assets and the respective investors, as well as own-funds’ requirements.
Pursuant to the most recent Annual Activity Report of the Portuguese Securities Commission on 2017 private equity investment (focused on venture capital activity), released on December 2018, the real estate sector was the target of around 10.3 per cent of the total value invested by Portuguese venture capital firms and funds; this means that from the €3,535.5 million invested by this sector in 2017, around €64.15 million targeted the real estate segment, the majority of such investment deriving from funds. In recent years the trend showed the increased weight of the real estate sector as a target of private equity investment in Portugal; in any case, the 2017 figures represent a small decrease in comparison with 2016, where the real estate sector was the target of 10.6 per cent of the total value invested.

As for real estate funds operating in Portugal (including investment funds, special funds and management funds of real estate assets), most recent available data referring to the end of the first quarter of 2019 reports the existence of 217 funds with €10.875 million of net asset value under management, this representing an increase of €37.3 million when compared with similar statistics reporting to the end of the first quarter of 2018. Statistical data shows their larger appetite to invest in offices or service-type assets (with €3,215.6 million invested), whereas commerce/retail assets take second place (with €1,993.6 million), followed by other types of assets and housing (representing, respectively, €1,724.7 million and €1,206.7 million), industrial assets (€318.1 million), tourism (€273.2 million) and logistics assets (€187 million).

It should in any case be noted that by the end of the first quarter of 2019, €7.8087 million was invested by real estate funds in completed construction, whereas land (€1.7167 million), other construction projects (€975.1 million) and rehabilitation construction (€135.1 million) followed investment preferences.

IV TRANSACTIONS

i Legal frameworks and deal structures

Overview

Typically, the sale and purchase of real estate assets can be structured either via a direct asset deal or, indirectly, via a share deal targeting the acquisition of the entire share capital or participation units of the company or fund that owns the relevant asset or portfolio.

Option between asset deals and share deals is driven by commercial or economic, financial, legal, tax and other considerations, but also taking into account the nature and type of purchaser and potential risks and liabilities susceptible of being inherited, with typical investors favouring asset deals. Potential ring-fencing concerns and legacy issues are also usually deemed as downsides to share deals (more appropriate for continuity solutions), although they have the advantage of allowing foreign investors to step into an already existing corporate vehicle with a low investment set-up. More complex corporate structures (such as mergers or demerges) are less common in effecting the transfer of real estate assets.

3 As per statistical information provided by the Portuguese Securities Commission in www.cmvm.pt/pt/Estatisticas.
4 As per statistical information provided by the Portuguese Securities Commission in www.cmvm.pt/pt/Estatisticas.
5 Assets may not be all located in Portugal.
A note should also be made to the potential qualification of asset deals as involving the transfer of an undertaking as a going concern, the dividing line being clearer in those transactions where the business performed in the target asset has more relevancy than the underlying property.

Transactions can either arise from private or off-market processes – the rule for traditional deals involving developers or a low number of assets – or be the result of organised competitive procedures, the latter being standard for processes involving high-profile assets or large portfolios, as well as whenever banks or listed entities are involved. The highly regulated profile and complexity inherent to bidding processes also makes them more lengthy and costly.

There is no standard time frame for the completion of a real estate M&A transaction, the duration of any deal depending on a number of factors, taking into account the risk-prone or risk-free approach of the parties, required regulatory clearances or filings, the option to dismiss or limit any due diligence exercise, as well as by the need to address or remedy any material issues arising thereof and considered critical.

As for the typical contractual conditions of real estate transactions, as a result of common-law influence any significant acquisition will follow international terms and clauses, both as to what concerns methodologies (such as the use of preliminary agreements, due diligence investigation) and the contents of contractual documentation (use of representations and warranties, indemnities, disclosures, etc.).

**NBO and due diligence**

The submission of a non-binding offer or letter of intent is usual in more complex or high-value transactions, in particular involving qualified investors, followed by the formalisation of a non-disclosure agreement regulating access to more detailed information concerning the asset.

The due diligence stage follows submission of the initial offers and may accommodate more than one investor reviewing the relevant information package. Legal due diligences have as their primary concern to identify any contingencies or negative consequences that may be triggered by the envisaged transaction, although different levels of analysis naturally apply depending on whether or not the operation is to be structured as an asset or share deal (for example, concerns around change of control or ownership provisions susceptible to motivating termination of key agreements or the acceleration of debt due under credit facilities or loans are more standard in share deals). The common backbone focuses, in any case, on the verification of ownership and encumbrances over the relevant real estate assets, tax status as well as on regulatory, planning and licensing requirements (including environmental) applicable thereto. High emphasis is likewise placed on the analysis and assessment of compliance levels under material agreements or other arrangements encumbering the asset (e.g., concession agreements, lease agreements or shop use agreements). Labour matters may also be relevant for share deals or whenever asset deals are susceptible of being configured as transfer of a business as a going concern.

Technical due diligence to the properties is also usually performed, entailing inspections and surveys to assess their suitability, construction status and existence of any structural or hidden defects. Verification of environmental matters, both from a legal and technical perspective, also assumes paramount importance to investors when perusing potential business opportunities, including assessment of the presence of any potentially hazardous or
dangerous substances in the properties. Finally, deals involving assets for development may also require careful review and validation of any approved or ongoing licensing procedures and urbanisation commitments.

**Deal security measures**

Typical deal security measures are normally deployed by qualified investors, often in conjunction with exclusivity negotiation periods. Exclusivity clauses are more usual in transactions with several interested investors, being demanded for reasonable periods of time (normally from 60 to 120 days, although no standard duration rule exists), in particular where one bidder seeks an exclusive negotiation period at an advanced stage of the process.

Far from being standard practice, break-up fees may be set in complex transactions, mostly seeking to protect the investor if a seller terminates negotiations at an advanced stage or elects another bidder. Although less usual, break-up fees may also be agreed to protect the seller in the cases where the sales procedure has a negative impact on ongoing businesses or on the overall value of the targeted asset.

Match rights’ undertakings may also be set forth in some transactions, awarding bidders the possibility of meeting or matching competitive offers presented by other interested parties.

When considering real estate transactions, pre-emption rights and other similar third-party rights are unavoidable to assess, either by clearing the risk in advance or otherwise developing strategies to deal with any such rights that may bring a degree of uncertainty to the deal until a very late stage of the process.

**Acquisition agreement terms**

**Promissory sale and purchase agreements**

Real estate transactions are commonly preceded by the execution of a binding promissory sale and purchase agreement, setting forth the reciprocal undertakings from seller and purchaser concerning the envisaged transaction.

This type of agreement is usual if execution of the transaction is subject to the fulfilment of conditions precedent (including, if applicable, anti-trust clearance) or conditional to the purchaser obtaining required financing. Typical conditions precedent in asset deals concern waiver of applicable pre-emption rights, notably from public entities (municipalities and state entities responsible for the safeguard and protection of historical and architectural heritage) as well as from tenants or other co-owners. As for share deals, most common conditions precedent relate to required consents or authorisations so as to avoid triggering change of control provisions or the acceleration of debt due under credit facilities or loans that are to be kept in place. In deals involving development projects, approval of envisaged planning may also be construed as a condition precedent.

Upon execution of a promissory agreement, a deposit is normally made as advance payment of due consideration, the percentage thereof varying as agreed by the parties (market practice often points to a 10–15 per cent range). As per default legal provisions, this deposit will be lost or will have to be returned in double if, respectively, the promissory purchaser or seller fail to execute the definitive agreement; in case the promissory purchaser was awarded possession of the property the same may opt to request the return of the deposit in single, but accrued of a compensation in an amount equivalent to the market value of the property at the date of breach, minus the agreed consideration. Alternatively, the non-breaching party may apply for the compulsory enforcement of the promissory agreement.
Also relevant in promissory agreements is the provision of the representations and warranties that are agreed by the parties and that are subject to repetition on completion date.

**Completion of the sale**

The sale of real estate requires execution of a public deed executed before a notary or, alternatively, sale and purchase agreement with certified signatures, or sale and purchase agreement executed before the land registry as per a relatively standard form (the last two options being less common in major transactions).

Execution of the sale is preceded by the verification of ownership of the seller over the real estate and of its capacity to dispose of the property. If existing, any charges or encumbrances over the property are usually discharged simultaneously with payment of the consideration (the most common being cancelling the mortgages). Subsequent registration of the acquisition is required before the land registry to prove ownership, as well as before the tax authorities.

As for share deals, completion does not require execution of any deed before a notary or even of an authenticated or notarised document, with the parties agreeing on the definitive transfer of the envisaged participating interest under a private document. Ancillary transfer formalities are, however, required, most notably delivery of share certificates (or deposit thereof in case of book-entry form shares) for share companies or registering the change of shareholding structure before the commercial registry in case of quota companies.

**Representations and warranties**

The most standard representations and warranties in any real estate M&A transaction concern the following topics:

- **capacity and authority of the seller;**
- **binding nature of the agreement and no contravention with other commitments or undertakings entered into by the seller;**
- **lawful title, possession and ownership over the relevant asset;**
- **no charges or encumbrances over the asset or limiting its use or transferability (being sold unoccupied of any persons or goods, with the exception of existing tenants, shopkeepers, etc.);**
- **validity of all licences, authorisations and permits required for the property;**
- **compliance with applicable legal provisions, namely on environmental, technical and safety requirements;**
- **suitability of the asset for the respective use and inexistence of hidden or structural defects;**
- **inexistence of pending or threatened litigation, claims or disputes susceptible of affecting the asset or the transaction; and**
- **inexistence of debts related to ownership and operation of the property, including due and proper payment of all taxes, charges and fees.**

Additional representations and warranties may also apply to share deals, in particular concerning ownership over the participating interest to be transferred, good standing of the entity to be acquired, compliance with agreements, as well as labour matters.
Guarantees and other
Protection from potential issues or contingences detected during the due diligence or that may arise post-completion is usually sought through a combination of specific indemnities and compensation for breach of the representations and warranties.

Furthermore, and so as to secure the seller’s obligations, it is also not uncommon for M&A deals targeting material assets to provide additional measures to mitigate the purchaser’s risk, including price retention or withholding (until certain milestones or conditions are verified), escrow agreement mechanisms, first-demand bank guarantees, parent company guarantees or comfort letters, among other things.

ii Hostile transactions
No hostile transactions have occurred with regard to public real estate companies.

iii Financing considerations
Funding used in national real estate M&A transactions follows standard financing schemes.

Typically, a loan agreement is entered into by the purchaser together with the associated security package (which is in line with international common practice), loan-to-value percentage varying on a case-by-case basis (despite usually fluctuating between 65 per cent and 80 per cent as the common maximum threshold).

The most frequent and relevant collateral in real estate deals is the granting of a mortgage over the target asset or portfolio. However, in share deals careful construction of the funding facility and security package is required in order to avoid financial assistance constraints (pursuant to which a target company is prohibited from supplying funds or providing any collateral so that a third party can acquire its share capital).

Security packages for transactions involving commercial real estate may also require the pledge of receivables or the assignment of receivables by way of security, as well as the assignment of income arising from real estate (mainly rents); in share deals, pledges over the target shares may also be required.

It should, however, be noted that the growing popularity of Portuguese real estate assets, by capturing the attention of international players, is bringing in a relevant inflow of foreign equity and therefore injecting additional liquidity and resources into the market.

iv Tax considerations
Taxes levied on the transfer and ownership of real estate
The acquisition of property and other rights over real estate located in Portugal is subject to property transfer tax (IMT) levied over the consideration paid or the tax registration value of the property, whichever is higher. The tax is levied at the rate of 5 per cent and 6.5 per cent, applicable to rural and urban properties respectively. Several exemptions may apply, including on the acquisition of properties for resale, urban rehabilitation or the acquisition of assets by real estate investment funds or companies for residential lease.

The acquisition of real estate is also subject to stamp duty at the rate of 0.8 per cent. This tax is levied on the same value that is relevant for IMT purposes.

6 The registration value is computed through the application of an objective formula, which normally results in a value lower than the property’s fair value.
The owner or the holder of usufruct or surface rights over Portuguese real estate is subject to a municipal property tax (IMI), levied on the tax registration value of urban and rural properties. IMI is due by the rightholder on 31 December of the relevant year, the tax being levied at rates varying (according to the municipality) between 0.3 per cent and 0.45 per cent for urban properties, and 0.8 per cent for rural properties. An ‘Additional to the IMI’ (AIMI) is levied on the sum of the tax registration value of all the urban properties held by each taxpayer, as at 1 January of each year, at the rate of 0.7 per cent for tax basis until €1 million, 1 per cent to the portion of the tax basis between €1 million and €2 million and 1.5 per cent over the tax basis exceeding €2 million.

**Share deals versus asset deals**

Gains realised by companies on the transfer of shares are subject to income tax at the rate of 22.5 per cent or 25 per cent for resident and non-resident entities respectively. Although gains on the transfer of shares by resident companies and by non-residents are generally exempt from tax in Portugal, this exemption does not apply to gains realised on the transfer of land-rich companies (companies in which the majority of its assets consist of real estate located in Portugal). Capital gains realised by individuals on the transfer of shares are always subject to a flat rate of 28 per cent.

Gains realised on the transfer of land-rich companies by non-residents are exempt under some double tax treaties, most noticeably the treaties with the Netherlands and Luxembourg.

Gains realised on the transfer of real property in Portugal are always subject to income tax in Portugal at the same rates described above. Note, however, that individuals (resident and non-resident) may elect to apply the general progressive rates on 50 per cent of the capital gain (in lieu of the flat rate). Only 50 per cent of the capital gains realised in the transfer of tangible fixed assets are included in the taxable income, provided that the realisation amount is reinvested in the two subsequent years.

The acquisition of a participation representing at least 75 per cent of the share capital of, inter alia, private limited liability companies by quotas is subject to IMT, levied at the higher of the tax registration value or the accounting value of the properties held by the company. No IMT applies on the transfer of shares in a corporation.

**Commercial operation of real estate**

Portuguese properties’ rental income is subject to income tax in Portugal. The tax is levied at the rate of 22.5 per cent or 25 per cent for companies, respectively resident and non-resident and 28 per cent for individuals. The rental income of resident individuals attributable to a business is subject to tax at the general progressive rates (up to 50.5 per cent on income in excess of approximately €80,000).

General business deductions are allowed, including amortisation and interest (up to 30 per cent of adjusted earnings before interest, tax, depreciation and amortisation or €1 million — whichever is higher). Individuals who are not deemed to be carrying out a business are allowed only maintenance and repair deductions.

**Investment vehicles**

The typical investment vehicles are companies and collective investment entities.

The most common structure is to hold the properties through a Portuguese corporation that is held by a Luxembourg holding company. The Portuguese company is funded through a mix of equity and debt. This structure may offset amortisation and interest expense against
most of the company’s operating income. Dividend and interest payments to the Luxembourg holding company should be exempt from tax under the parent-subsidiary and interest and royalties directives. Capital gains on the sale of the Portuguese company’s shares are exempt from tax under the Luxembourg-Portugal tax treaty.

Also common are investments through OII under the form of real estate funds or companies. These are subject to a special tax incentive status regime that, following a 2015 amendment, is based on the ‘exit’ taxation method, thus aligning it with similar tax regimes of most jurisdictions and allowing for an easier comparison between domestic and international collective investment entities.

Although collective investment entities are subject to income tax, the following classes of income are exempt: capital income (property income and capital gains) and expenses related thereto, except from offshore entities; certain non-deductible charges for tax purposes; income and expenses related to management and other commissions that reverted to the entities.

Distributions and redemption gains realised by participation unit holders are subject to taxation at 25 per cent or 28 per cent (for resident corporate entities or individuals, respectively) or 10 per cent (to non-residents). Gains realised by non-residents on the transfer of participation units are exempt from tax in Portugal.

**Cross-border complications and solutions**

As a general rule, in Portugal there are no restrictions on foreign investment, which is granted the same level of protection as domestic investment, no specific registration or legal or regulatory protection measures applying. Other than in specific sectors (in particular in those that may affect the public order or the public health, involve the exercise of a public authority or relate to national security), there are no particular limitations on foreign investment, although a number of restrictions and consent requirements may apply both to foreign and domestic investments in regulated areas.

In what specifically concerns transactions targeting real estate assets, it should in any case be noted the more stringent legislative package approved in 2017 concerning, on one hand, anti-money laundering and anti-terrorism funding measures (as per Law 83/2017), and, on the other, the obligations concerning identification of the ultimate beneficiary holding direct or indirect control over legal entities (pursuant to Law 89/2017).

In line with these requirements, know your customer procedures performed by collective investment entities and financial entities also entail the disclosure of extensive information from the counterparties, bringing additional clarity and transparency to transactions.

**CORPORATE REAL ESTATE**

Following the Portuguese bailout programme (that officially ended in May 2014) and in the wake of the austerity policies enforced thereunder, a tendency was noted for Portuguese businesses to refocus on their main activities while disposing of assets and businesses that...
were not essential. This divestment trend created attractive opportunities in the commercial real estate sector, with mostly international players (without liquidity constraints) seeking to take advantage of the sale of quality assets at very competitive prices during the crisis years.

Some national groups have also undertaken corporate restructures with a view to segregating their real estate assets from their operational activities, although no reference can be made to a substantial track record in this respect.

Other than that, the most typical procedure for monetising corporate real estate has consisted of sale and leaseback-type operations, favouring either purchasers from the financial sector or real estate investors with an appetite for core assets with low risk that can provide a stable yield.

VI OUTLOOK

2019 is expected to be another year of growth, although it is unlikely that it will surpass the records set in 2018. Despite more modest expectations (with investment in commercial real estate being estimated to reach around €2.5 billion), 2019 should remain well above the average of the last decade, as a stable political environment and recovering economy continue to make Portugal a preferred target for foreign investment. Prime yields should linger around 4.5 per cent in office and street retail, 4.75 per cent in shopping centres and 6.5 per cent in logistics.

The shopping centre market has reached maturity, with a residual offer growth of 50,000 square metres in new GLA being mostly due to expansions and renewals of already existing schemes. The lack of retail real estate should therefore confirm a shift in investment preferences, with the office and logistic sectors playing a larger role together with alternative assets, such as hospitals and other collective equipment. The new concepts of co-living and co-working will increasingly become part of the landscape, as student housing, senior residences and work hubs capture investment interest. Hotel and tourism-related assets should also remain an appealing investment option, as Portugal continues to be an on-trend destination.

The scarcity of big-ticket deals means that the development of new assets will be critical for a sustainable pipeline, with rising construction costs and scarcity of workforce being a point of concern. Although more conservative in terms of investment profile, residential development is required to flourish whilst expanding city boundaries, in particular aiming at the national middle-class segment often seen as the engine of the lease market, even more so considering that residential pricing is too high for the average income level.

The banking sector should continue offloading NPL and REO portfolios into the market, as a value between €25 billion and €30 billion in NPL portfolios is purported to still be up for sale, in what are expected to be very disputed deals with opportunistic investors seeking an alternative to the stock market and to low interest rate returns.

As for the Portuguese REITs (SIGIs), these should only have an impact from 2020 onwards, as now is the time to incorporate the first vehicles and gather capital for investment.

However, difficulties are posed by some contradictory legislative policies; in the same year that saw the Portuguese REITs come to light, the urban lease law suffered significant amendments hindering the incorporation of a professional residential lease market in Portugal, by offsetting the flexibility introduced in 2006 with a view to, at the time, strengthening the rental market.
Chapter 19

RUSSIA

Sergey Kolobov

I OVERVIEW OF THE MARKET

In the boom years, Russia was one of Europe’s largest property markets, with investment volumes of US$8 billion–US$10 billion annually; the figure briefly decreased during the 2008–2009 financial crisis.

However, a downward trend on the property market began in 2014, which continued through to early 2016, in sync with the political challenges that Russia is facing as a result of continuing Western sanctions and low oil prices (on average), which has brought about a weakening of the Russian currency.

In 2018 the Russian economy slowed down, with the inflation rate at 4.2 per cent. The GDP growth appears to be less than expected and is estimated to be 1.5 per cent according to the Accounts Chamber of Russia.

Following a decline in the economy, the investment activity has shown a negative trend: the total volume of investments in commercial real estate in Russia amounted to US$2.4 billion, which is about half the level of the previous year. High volatility in the currency markets, the escalation of geopolitical tensions and the instability of debt financing during 2018 were the reasons for the lowest figures in the past 13 years. An additional trend of 2018 is that more than half of the total investment in 2018 was formed through classical investment transactions.2

The office segment regained its leading position in 2018, comprising 47 per cent of the total invested amount. The retail sector dropped by 31 per cent in comparison with 2017 and attracted 30 per cent of the total invested amount.3 The share of foreign capital in the real estate investments market drastically increased from a record low 2 per cent in 2016 to 18 per cent in 2017.4 The increase continued in 2018 and now amounts to 24 per cent.5 The most active investors were from Kyrgyzstan, the Czech Republic, the UK, France and Finland, as well as banks and global investment funds.

Moscow consistently remains the most attractive city for investors in Russia, with a 74 per cent share of the total volume of investments. St Petersburg’s share is also stable and accounts for 21 per cent.6

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6 Knight Frank.
The Russian commercial real estate market is fairly diverse and institutionalised with about 30 major players, including seven foreign companies (e.g., Ingka Centres, (formerly IKEA), Raven Property Group, Hines and Morgan Stanley Real Estate Investing) with annual rental revenue ranging from US$1.5 billion (Kiyevskaya Square group companies owned by Zarah Iliev and God Nisanov) to US$50 million (Atrium European Real Estate) in 2018. The Russian real estate market lacks any substantial public real estate companies, except for several residential developers listed on the Moscow Stock Exchange (e.g., PIK Group and LSR), as well as the major warehouse owner – Raven Property Group – listed on the London Stock Exchange, so deals are more often structured through non-public sale and purchase agreements of shares in a company holding the desired properties.

REITs are not present on the Russian real estate market, although a common way of investing in real estate is through investment funds, especially those which possess certain analogous characteristics to REITs (Section III). The most common investment fund in the Russian real estate market is a closed-ended investment fund (CEMIF).

As of 2018, the net asset value of real estate CEMIFs amounted to US$7.8 billion, representing a 17 per cent share in the Russian mutual investment funds market. This share has, however, significantly decreased by 16 per cent in comparison with 2016, largely as a result of a continuing fall in profit of CEMIFs. For 2018, real estate CEMIFs showed a positive yield (1.9 per cent per annum).

II RECENT MARKET ACTIVITY

M&A transactions

As mentioned above, the Russian real estate market does not have a significant public sector, therefore we have selected the following transactions involving sophisticated market players that focus on real estate investments, as well as major corporate real estate transactions.

a Sberbank’s (one of the largest Russian banks) purchase of business centres Mirax Plaza and Suvorov Plaza: the estimated deal price is US$769.2 billion.

b Yandex (one of the largest IT companies in Russia) purchase of a land plot for the development of a new business centre: the estimated deal value is US$145 million.

c FC Otkritie (one of the Russian financial groups) purchase of business centre Legion 1 in the centre of Moscow from Legion Development (following bankruptcy proceedings in 2018): the estimated deal value is US$153 million.
Private equity transactions

We have selected the following significant private equity transactions involving, inter alia, foreign real estate private equity (PE) firms:

\( a \) A company associated with PIK (one of the largest Russian developers) shareholder Mr Sergey Gordeev selling shopping mall Riviera to KLS Eurasia Venture Fund, a company under control of Kyrgyz company KLS Securities owned by Vladimir Kirusha. The market price for the mall is US$350–US$400 million.\(^{13}\)

\( b \) Stockmann (a Finnish retail group) selling in 2018 shopping mall Nevski Centre in St Petersburg, one of the biggest shopping malls in St Petersburg, to PPF Real Estate (a major player in the Russian commercial real estate market): the estimated deal value is €171 million.\(^{14}\)

\( c \) Vanke China (one of the biggest real estate companies in China) buying a complex of historical buildings in Moscow: this is considered the biggest real estate deal of 2018 in Russia, however the deal value was not publicly disclosed.\(^{15}\)

III REAL ESTATE COMPANIES AND FIRMS

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

As mentioned above, Russian law has not yet incorporated the concepts of REITs and REOCs. However, mutual investments in Russian real estate are permitted through an investment fund, which is an asset portfolio consisting of assets placed under the management of an asset management company. There are different types of investment funds, though only two types of such funds may invest in real estate: CEMIFs and joint stock investment funds. We note that real estate joint stock investment funds are not particularly widespread and their market share is insignificant in comparison to CEMIFs.

The assets that comprise the CEMIFs and joint stock investment funds must be managed by an asset management company (the AMC). Investment shares under management must be accounted for with a special depository. A special depository is a licensed entity which controls the compliance of an AMC’s activities with regard to abiding by legal requirements and trust management agreements. The specialised depository is responsible for the safekeeping and accounting of the investment funds’ assets.

The investment funds may pay dividends (in the case of joint stock investment funds) and may, if the investment policy permits distributions to investors, distribute income from management (in the case of CEMIFs).

Only ‘qualified investors’ may invest in these specific funds that invest in real estate (see the section below for more details).

Joint stock investment funds

A joint stock investment fund is a joint stock company that has a licence from the Central Bank of Russia for the purpose of investing in assets in accordance with its investment policy. It may invest in real estate and be listed on the stock exchange.

Shareholders may pay for shares of a joint stock investment fund in cash or in any other asset permitted by the fund’s investment policy. As opposed to CEMIFs, joint stock investment funds can exist for an indefinite term. Shareholders of a joint stock investment fund generally do not have the right to demand redemption of their shares.

The main difference between joint stock investment funds and CEMIFs is that the former is a legal entity and its shareholders do not directly own the assets comprising the
fund. On the other hand, a CEMIF is an asset portfolio rather than a legal entity, therefore its participants have direct ownership rights to the underlying asset, which is deemed to be the common property of the CEMIF’s participants. This is one of the reasons, along with certain administrative complications and low liquidity, why joint stock investment funds are very rare in the Russian market.16

**CEMIFs**

Similarly to joint stock investment funds, a CEMIF is placed under the management of an AMC and can be funded by cash or by any other asset permitted by the fund’s investment policy. Each fund investor agrees to the fund management rules with which the AMC has to comply. The assets of all fund investors create a pool. A participation unit from the AMC evidences a share in the funds’ property. Generally, bankruptcy of the AMC does not affect a CEMIF’s assets as they are legally separated.

CEMIFs distribute to the investors a fixed number of units, only redeemable on expiry of a trust agreement or on the occurrence of certain other events specified by applicable law. However, the unitholders are not restricted in their right to sell their units to third parties or, if the fund is designated as such, to ‘qualified investors’.17

CEMIFs cannot be established for a period longer than 15 years. CEMIFs can be listed on a stock exchange but its units do not have the same liquidity as shares. To dispose of the units on a stock exchange, a unitholder has to involve the AMC, which significantly prolongs the sale process.

The capital markets legislation imposes special requirements on the assets that may comprise a real estate CEMIFs and, if such CEMIF’s assets do not meet the requirement, only ‘qualified investors’ may acquire the units. In particular, the general public may acquire the units of a real estate CEMIFs if its assets consist of only:

- residential properties;
- non-residential properties in a condominium;
- certain other non-residential properties meeting specific criteria;
- residential properties in non-residential buildings;
- unified real estate complexes;
- engineering infrastructure related to other funds’ assets;
- land related to other funds’ assets;
- leasehold related to other funds’ assets;
- common construction schemes;
- money-market instruments; and
- properties related to management or payment for management of the funds’ assets.

However, there is a further condition that makes CEMIFs less attractive to the general public – only qualified investors may acquire units of a real estate CEMIFs if: (1) the minimum tranche for the units is less than 300,000 roubles (approximately US$5,000)18 (including any units that an investor may acquire in addition to the units it already owns); and (2) the managing company has the right to split the units.

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16 According to Central Bank of Russia, at the end of third quarter of 2017 there were only three such funds with total net asset value of US$70 million.

17 ‘Qualified investors’ are individuals or legal entities meeting certain criteria provided in the legislation and generally considered as sufficiently experienced participants of the market.

18 The rouble/US dollar exchange rate is 60 roubles to US$1.
In practice, most real estate CEMIFs are either controlled by the major Russian banks (e.g., Sberbank, VTB) or property developers. However, the largest real estate CEMIF (Dom.RF) is controlled by the Moscow government and its main purpose is to provide residential financing to individuals. Standard portfolios of real estate CEMIF comprise residential property.

Compared to REITs, real estate CEMIFs have the following unique characteristics:

a CEMIFs are not legal entities;
b CEMIFs can only be closed-ended;
c usually CEMIFs are not listed; however, this is not legally restricted;
d CEMIF’s lifespan is limited to 15 years; and
e investments in CEMIFs are less affordable for the general public.

ii Real estate PE firms – footprint and structure

Owing to economic instability and currency volatility in Russia over the past few years, PE firms have been less active in the real estate sector. Significant drops in rent revenues and change of fixed rent rates from US$ to roubles have made the formerly lucrative market less profitable, especially taking into account challenging market conditions. Pure private equity deals in Russian real estate have become quite rare.

PE companies in the Russian market are acting mainly through offshore vehicles. The choice of jurisdiction will largely be driven by tax issues and corporate considerations (Cyprus and BVI remain the most popular jurisdictions).

In Russia it is more common for PE investors to take minority stake investments. Where control is acquired, these investments tend to be carried out by way of a consortium deal. One of the main drivers for this is financing. As with any jurisdiction, investors can access larger deals by clubbing together, but this increased financial resource is particularly relevant in the Russian Federation where deals tend either to involve limited debt financing or none at all.

Finance is just one reason why foreign investors often seek out locals to partner with; Russia also has a reputation as a jurisdiction in which it is desirable to have a strong local partner to achieve a successful business operation. A local partner brings local knowledge and connections that can be indispensable for foreign investors who are unfamiliar with the Russian regulatory system and lack relations with the Russian authorities. Partnering with a local PE house may make obtaining investment committee consent easier, as reassurance is taken from the experience, expertise and influence of the domestic partner. For the Russian investor, involving an international partner may provide access to funding from banks based in the same overseas jurisdiction as the foreign investor and carries with it a certain cachet that can be of particular leverage when trying to negotiate an exit. In addition to funding, international investors can bring a greater depth of deal experience and sector knowledge to what is still a relatively immature PE market.

IV TRANSACTIONS

i Legal frameworks and deal structures

There are two main structures for the acquisition of real property: asset purchase (acquisition of real property directly from its owner) or share purchase (acquisition of a holding company that owns relevant real property).
Asset purchase

Where a deal is structured as an asset transfer, the target’s liabilities, including tax liabilities and penalties, should not (subject to careful structuring) transfer to the purchaser.

An asset purchase is not, however, a perfect solution for the following reasons:

a. there remains a risk that the Russian tax authorities could recharacterise the asset transfer as a ‘sale of an enterprise’ under which historic liabilities would be treated as transferring to the purchaser; and

b. the authorities may attempt to establish that an asset transfer constitutes a fraud against creditors if it is proved that it was designed to evade historic liabilities.

In addition to the risks described, the key disadvantages of a sale of assets are as follows:

a. administratively, they are more cumbersome than an acquisition of shares;

b. the acquisition may require obtaining new licences and permits, or the novation or assignment of contracts; and

c. the acquisition may lead to Russian VAT being payable.

A typical sale and purchase transaction is a two-stage process involving the execution of a sale and purchase agreement and registration of the transfer of title onto the Unified State Register of Real Estate. The sale and purchase agreement must be a single written document.

The handover of the property is effected by completing a document that formally conveys the property from the seller to the buyer (an act of transfer and acceptance).

As a general rule, if a building or other immovable facility and the underlying land are owned by the same person, a sale of the building without the underlying land (and vice versa) is not allowed. If the land is owned by someone other than the owner of the building, the building can still be sold, and the new owner will enjoy the same rights to use the respective part of the land plot underlying the building as the previous owner of the building.

Share purchase

Share purchases are a very popular way to acquire real property in Russia. The major risk of a share acquisition is, of course, that a buyer will also assume all of the target’s existing liabilities (subject to any contractual apportionment and post-acquisition risk mitigation strategies). This means that thorough due diligence of the historic activities of the target is crucial.

There are, nevertheless, numerous advantages in a share purchase structure, chief among which are avoiding the need to reapply for licences and permits, a less complex and burdensome acquisition process, no Russian VAT (although please see below certain new developments in relation to application of Russian VAT to share deals) and the avoidance of business interruption.

Acquisition vehicle

If the target company does not have a dedicated offshore holding company, it may be advisable to set up a holding company to make the acquisition or, in the case of an asset transfer, to create an offshore holding company with a wholly owned Russian subsidiary (the latter subsidiary being the recipient of the transferred assets). The choice of jurisdiction will largely be driven by tax issues and corporate considerations.

CEMIFs, not being a legal entity, do not participate in any kind of M&A activity.
ii Acquisition agreement terms

Proper PE or M&A transactions traditionally start with the due diligence exercise. There is no standard approach to performing due diligence on Russian assets. Some buyers take the exhaustive, forensic approach normally associated with foreign strategic bidders, whereas others are happy to ‘kick the tyres’ and place more heavy reliance on the deal protections offered by way of warranties and indemnities (see further below). The approach of PE sponsors in Russia sits perhaps half-way between these two extremes – PE sponsors are acutely aware of customary risks in a particular sector or asset class, and are therefore keen to avoid the costs and delays associated with compiling lengthy confirmatory diligence reports.

Since Russian law provides for a strict rule that any transaction involving real property is subject to Russian law, effectively applying the principle of *lex rei sitae*, the asset deals are documented as Russian law sale and purchase agreements. In recent years, Russian law has implemented several English law concepts such as warranties and indemnities. Therefore, if for certain commercial reasons sophisticated market players decide to acquisition property as an asset deal, Russian law acquisition agreement are drafted in very similar terms as a standard English law share purchase agreement. However, as mentioned above, sophisticated players still prefer to structure their investments in Russian real estate under English law share purchase or framework agreements.

Warranty packages are usually the most negotiated area in real estate acquisition agreements. The exact set of warranties heavily depends on the type of the real property acquired but usually includes title and no encumbrances warranties, property condition, compliance with building laws warranties and warranties in relation to the leases (usually in relation to commercial property). PE investors typically expect more detailed and longer-form warranties than other bidders, but as warranty packages expand in the market in general, PE investors are less likely to be considered out of tune with competing bidders for an asset. As warranties have expanded, so too has the scope for indemnities. Tax and title to group companies and real property are now, more often than not, accepted as a starting point for a discussion of indemnities, with further requests being made on the basis of due diligence findings.

In terms of consideration, payment under real property acquisition agreements in the highly competitive Russian real estate market encourages cash deals.

Another important and heavily discussed term of the real property acquisition agreement is price adjustment. For many years, post-closing adjustments in Russian private M&A and PE transactions took the form of traditional completion accounts; accounts drawn up as of the completion date, and delivered by a reporting accountant after closing. This would often involve crucial negotiations regarding the security for any clawbacks or downward price adjustments (typically in the form of deferred consideration or escrows).

However, as parties have sought to simplify deal making, and IFRS has become increasingly applied in recent years, there has been a marked shift towards the use of some form of locked-box mechanism – whereby the seller warrants the financial position on an accounts date, and undertakes not to permit any unforeseen leakage from the date of the locked-box accounts until closing. Dealmakers sought to avoid the uncertainty, cost, inconvenience, delay and adversarial discussion that a completion accounts mechanism often brought.

One of the most important differences between asset deal acquisition agreements and share deal acquisition agreements is the approach to signing and completion. With share purchase agreements, the market tends to favour simultaneous signing and completion.
or at least a very short period between signing and completion, and no, or limited, post-completion obligations. On the other hand, with asset deal acquisition agreements, signing and completion are always separated due to title registration requirements, unless the parties agree on a different concept of ‘closing’ (e.g., actual transfer of property versus consideration instead of registration of title vs. consideration). This, in turn, influences the payment structure, which may consist of pre-completion, completion and post-completion payments.

### iii Hostile transactions

Owing to the lack of a public M&A market in the Russian real estate sector, there are no hostile takeovers in this area.

### iv Financing considerations

Acquisition finance to leverage M&A or PE transactions in the real estate market is not a prevalent feature of real estate investment in Russia. The significant majority of deals are equity only and with increasing restraints on access to international finance markets, the ability to ‘self-fund’ is more important than ever. That said, there are examples of state banks providing debt financing for acquisitions. Domestic financial institutions and funds such as VTB Capital, Sberbank CIB and RDIF can at times offer the ability to refinance post-investment, which gives them a competitive advantage over other PE sponsors, for example.

### v Tax considerations

Generally, both Russian tax resident and non-resident companies are subject to corporate profits tax on capital gains on any disposal of Russian real estate, at a general rate of 20 per cent. In addition, the sale of real property (except for residential property and land) is subject to Russian VAT at the rate of 18 per cent.

As mentioned above, it has been common for Russian real estate owners to structure real estate sales through a share deal, often by selling offshore vehicles. The reason for that was that share deals were not subject to VAT in Russia, and in some cases, profits tax could be eliminated via the application of a double tax treaty relief on the disposal of shares. However, Russian tax authorities have started scrutinising the share deals concealing the virtual sale of real estate in order to avoid VAT. Furthermore, during the last few years, many treaties Russia is a party to have been amended to tax disposals of shares of real estate companies (i.e., the assets of which directly or indirectly consist, by more than 50 per cent, of real estate located in Russia) in the same manner as the sale of real estate.

Real property owners, irrespective of tax residence, are also subject to property tax and – in respect of land – to land tax (rates vary depending on the region and type of asset).

As noted above, CEMIFs are not legal entities and are not consequently taxpayers; the management company of the fund pays property tax and land tax, as applicable; it also pays VAT in the case of disposal of real property. However, the management company pays profit tax on its remuneration only, and it is not taxable on income from the disposal or rent of real property, which basically allows a CEMIF to reinvest its income without losing its profit due to tax.

The unit holders only pay their profit tax or personal income tax at the moment of disposal or redemption of the unit, and distribution of the fund’s profit to them. For this
reason, real estate unit investment funds are presently a popular tool allowing for legitimate income tax deferral. Russia has started reconsidering its double tax treaties to apply profits tax to the capital gains realised by foreign participants in the real estate unit investment funds.

vi Cross-border complications and solutions

Most PE deals relate to Russian targets and given the current political, economic and regulatory conditions in Russia and the novelty of Russia as a jurisdiction attracting PE investment in the real estate sector, foreign investors are still in the minority. The bulk of the M&A and PE transactions, therefore, involve the acquisition of Russian real estate by Russian bidders. Nonetheless, these deals have traditionally had a strong cross-border element since, as a result of various tax, regulatory and legal considerations, the deals still tend to be structured using offshore acquisition vehicles.

Typical challenges to be dealt with on cross-border transactions in Russia include the increasingly complex regulatory landscape and marrying the applicable requirements of the Russian legal system with those of the chosen governing law of the transaction; sanctions issues; the rapidly evolving taxation regime; the lack of established market practice and relatively few precedent deals against which to benchmark transactions; the related lack of experience of PE deal-making among the business community; and managing relations with the Russian regulators and government.

Russian legislation dealing with controlled foreign corporations (CFCs), which came into force in 2015, has continued to develop in 2016–2017. Although broadly consistent with the OECD and EU approach, these rules remain widely untested in the Russian legal framework and have already started heavily influencing the choice of investment structures.

The Russian CFC legislation sets out rules in the following four areas of tax structuring. First, it addresses the taxation of profits received by the controlled foreign companies of Russian residents but not yet received by the Russian residents themselves. Second, it requires Russian residents holding shares in, or controlling, foreign companies or non-corporate entities to notify the Russian tax authorities of such shareholding or control. Third, it lays down the test for determining the tax residency of legal entities, and lastly, it introduces the concept of beneficial ownership of income for the purposes of double tax treaties.

It is clear from the new law and recent court practice that the aim of the Russian government is to restrict the availability of double tax treaty benefits for recipients of Russian-source passive income where offshore structures are deliberately established to obtain tax treaty benefits for the ultimate beneficial owners of such income. This focus of the government’s recent reforms is of key importance to the private equity sector.

V CORPORATE REAL ESTATE

Since there is no specific incentive (tax or otherwise) to separate corporate real estate from operating companies such transactions are not common in Russian market.

VI OUTLOOK

As mentioned, market conditions have dampened the enthusiasm of many international investors (with the notable exception of Chinese funds) to invest in Russia, and made fundraising more challenging. That said, existing capital is being deployed by opportunistic foreign investors with higher risk appetites and local players with deep experience. Among
this number are Chinese state-owned funds and companies which have shown some interest in Russian commercial real estate, and it is anticipated that they will dominate the investment sphere in the coming 12 months, in line with the Chinese government’s policy to focus investment along the old ‘Silk Road’.

The continuing development of the Russian government’s de-offshorisation programme has had an impact on overall investment activity. This, together with changes to the Russian Civil Code aimed at creating a more flexible onshore legal environment, may put further pressure on Russian investors to return capital to Russia and to invest directly in Russian companies. The traditional approach of structuring deals using overseas intermediaries noted above, may now be in question as a result of this de-offshorisation drive.

How the major players in the Russian real estate market respond to these economic, political and regulatory challenges will be a key factor in determining whether Russia can develop a PE real estate market with substantial scale, depth and liquidity.

Traditional share deal approaches used for selling and acquiring Russian real property may also significantly change owing to major reform in Russian civil law, which started in 2012. It was expected that the whole section of the Russian Civil Code regarding real property would be completely redrafted by introducing new in rem rights. However, this reform was postponed for an indefinite term.
I OVERVIEW OF THE MARKET

Since the listing of the first real estate investment trust (REIT) on the Singapore Exchange (SGX) in July 2002, the Singapore REIT (S-REIT) market has grown rapidly. With a total of 44 S-REITs and property trusts currently listed on the SGX as of the end of May 2019, the S-REIT market is now the largest REIT market in Asia ex-Japan with a market capitalisation of approximately S$100 billion.

The enduring popularity of S-REITs has helped to strengthen the SGX’s status as an Asian REIT hub, with S-REITs forming a cornerstone of Singapore capital markets. S-REITs make up one-tenth of the FTSE Straits Time Index (STI) stocks, all of the STI Reserve List stocks and approximately one-tenth of the total market capitalisation of stocks listed on the SGX.2

Reflecting Singapore’s international outlook and outward-looking perspective, more than 80 per cent of the S-REITs and property trusts listed on the SGX have invested in assets outside Singapore, initially in jurisdictions across the Asia-Pacific, but with increased focus on Europe and the United States in recent years. In 2018, Singapore capital replaced Chinese capital as the major Asian investor in global property markets, with capital flows from Singapore reaching US$18 billion, comprising 36 per cent of total capital from Asia.3

Given Singapore’s small geographic size and limited supply of land, it is natural that S-REITs have increasingly looked to overseas markets to grow. S-REITs now represent an established ready source of capital from Singapore for real estate investment both onshore and offshore, while providing a transparent and liquid market for institutional and retail investors to access a wide range of asset classes in diverse geographies. 2018 saw the largest amount of capital raised on the SGX through secondary offerings in the last eight years, with approximately S$4.3 billion raised by S-REITs and property trusts, primarily to finance new acquisitions.

As a leading wealth management hub with over S$3 trillion assets under management in Singapore, S-REITs are able to benefit from a wide pool of global and Asian institutional investors, private wealth investors and family offices. While the S-REIT space has traditionally been dominated by local developers and fund managers, an increasing trend observed is for overseas sponsors, lured by the access to capital and by the openness to overseas investments, to seek REIT listings on the SGX for their offshore assets.

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The broader Singapore commercial real estate sector has also seen considerable activity from private equity (PE) funds attracted by the access to capital and talent, ease of investment and a favourable tax regime. The regulatory framework for fund managers solely managing PE real estate funds affords quite a lot of flexibility, with exemptions from licensing requirements generally available for such fund managers. The Singapore market also remains attractive to PE funds that are less constrained than S-REITs by the hunt for yield accretive acquisitions and by leverage limits. In particular, foreign PE funds have been active in the Singapore market, with several investors such as Allianz Real Estate, Gaw Capital (a Hong Kong-based PE firm) and Kenedix Inc. (a Japanese real estate fund management company) making their maiden investments into the Singapore real estate market in 2018.

Local real estate companies have also long utilised PE fund platforms as an alternative investment structure to expand their investor base and diversify their sources of capital. In recent years, they have continued to expand rapidly in this space and offer novel products in diverse asset classes, including Mapletree Investments which closed the first private fund in Singapore focused on student accommodation assets with US$535 million of equity, CapitaLand which raised US$391 million for its first discretionary PE fund which will invest in value-add and transitional office buildings in Asia’s key gateway cities and Keppel Capital’s tie-up with MindChamps PreSchool to establish a new PE fund to invest in preschool and early learning real estate assets in the Asia-Pacific region.

The continued growth of the S-REIT and PE real estate market has led to real estate transactions being highly securitised and increasingly complex, with investors becoming more sophisticated and often utilising novel structured financing to acquire assets in the most tax efficient manner. Transactions often involve cross-border elements, with issuers and professionals required to manage multiple workstreams across legal, tax and financial aspects.

### II RECENT MARKET ACTIVITY

#### i M&A transactions

There has been an increasing trend of large high-profile M&A transactions involving S-REITs and real estate companies. Some of the major recent transactions include:

- **CapitaLand’s proposed acquisition of the business of Ascendas-Singbridge for approximately S$6 billion to be satisfied in cash and new shares, which was announced in January 2019.** Upon completion, the combined total assets under management of CapitaLand will exceed S$116 billion, putting it among the top 10 real estate investment managers globally, as well as the manager of the three largest S-REITs, namely Ascendas Reit, CapitaLand Mall Trust and CapitaLand Commercial Trust;

- **CapitaLand’s and City Development Limited’s joint acquisition of Liang Court mall for S$400 million from PGIM Real Estate’s Asia Retail Fund, the largest non-listed retail mall fund in Singapore, which was completed in June 2019;**

- **Frasers Property Limited and Frasers Centrepoint Trust acquiring additional stakes in PGIM Real Estate’s Asia Retail Fund to around 47.8 per cent and 18.8 per cent respectively for an aggregate consideration of around S$635 million in March 2019;**

- **OUE Commercial REIT’s proposed merger with OUE Hospitality Trust by way of a trust scheme with OUE Commercial REIT acquiring all of the stapled securities of OUE Hospitality Trust for approximately S$1.5 billion to be satisfied in cash and new...**
units, which was announced in April 2019. Upon completion, OUE Commercial REIT will become one of the largest diversified S-REITs with total assets of approximately S$6.8 billion;

e ESR-REIT’s merger with Viva Industrial Trust by way of a trust scheme with ESR-REIT acquiring all of the stapled securities of Viva Industrial Trust for approximately S$936.7 million in cash and new units, which was completed in October 2018. Post-completion, ESR-REIT has become the fourth largest industrial S-REIT with total assets of approximately S$3.0 billion;

f Frasers Logistics & Industrial Trust’s acquisition of a portfolio of 21 industrial properties in Germany and the Netherlands from a subsidiary of its sponsor for approximately S$972.2 million, which was completed in May 2018. This was Frasers Logistics & Industrial Trust’s maiden entry into the European market, expanding from its initial focus on Australia;

g City Developments Limited’s acquisition of a 50 per cent stake in the REIT manager of IREIT Global from Tikehau Capital, a pan-European alternative asset management and investment group and the existing sponsor of the S-REIT, and a 12.4 per cent stake in IREIT Global from certain major unitholders; and

b OUE Limited’s acquisition (together with its subsidiary) of the REIT manager of First REIT and a 10.6 per cent stake in First REIT from its sponsor, PT Lippo Karawaci Tbk.

ii Private equity transactions

PE funds have been active in real estate M&A and there have been several notable transactions some of which include:

a the privatisation of Global Logistics Properties Limited, which owns a global portfolio of warehouses and other logistics facilities, by way of a scheme for approximately S$16 billion by a consortium of Chinese PE investors including Hopu Investment Management, Hillhouse Capital, Vanke Group and Bank of China Group Investment in January 2018. This is the largest PE buyout of an Asian company to date;

b the privatisation of ARA Asset Management (ARA), a Singapore-based global integrated real estate fund manager, which manages multiple REITs and private funds, for approximately S$1.8 billion by a consortium including Warburg Pincus, a unit of AVIC Capital Co and certain existing investors in April 2017;

c several transactions by AEW in the Singapore market in the last two years, including acquisitions of Twenty Anson and 55 Market Street from S-REITs and the divestment of Rivervale Mall to SC Capital Partners, a Pan-Asian real estate investment firm;

d ARA’s joint acquisition with British property group Chelsfield, through their respective private funds, of Manulife Centre for S$555.5 million from City Developments Limited and a fund managed by Keppel Capital in January 2019;

e Gaw Capital’s acquisition of Robinson 77, a Grade A office building in Singapore, from a fund managed by CLSA Capital Partners for approximately S$710 million in February 2019;

f Allianz Real Estate’s acquisition of a 20 per cent stake in Ocean Financial Centre, a Grade A office building in Singapore, from Keppel REIT for approximately S$537.3 million which was completed in December 2018;
CapitaLand’s joint acquisition, through its Raffles City China Investment Partners III fund, of Raffles City The Bund, Shanghai’s tallest twin towers, in a 50:50 joint venture alongside Singapore’s sovereign wealth fund, GIC, for approximately S$2.54 billion, which was announced in November 2018; and an affiliate of Lone Star Funds’ acquisition of Saizen REIT’s entire portfolio of Japanese residential properties for approximately S$517.3 million, which was completed in March 2016. Upon completion of the sale, Saizen REIT became a cash trust and it was proposed to be the subject of a reverse takeover by Sime Darby Group through an acquisition of certain of Sime Darby’s industrial assets in Australia which ultimately fell through. Saizen REIT subsequently was the first S-REIT to be delisted.

III REAL ESTATE COMPANIES AND FIRMS

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

S-REITs are collective investment schemes which are structured as unit trusts with a separate trustee and manager. Unlike retail unit trusts which are typically open-ended investment vehicles, S-REITs are closed-end and do not permit redemption of units at the option of their investors. Practically, this has little impact on investors’ liquidity as S-REITs are listed on the SGX and investors are free to buy and sell units on the market.

To date, all S-REITs have adopted an externally managed structure, where the REIT manager is a Singapore-incorporated private company that is typically owned by the sponsor of the S-REIT. Unlike certain other mature REIT regimes where internalised managers have become the norm, S-REITs have so far eschewed internalised management models despite the oft-touted cost savings. This may be because investors still place more importance on S-REITs having the backing of a reputable sponsor with a strong pipeline of assets and experienced and professional management teams. In turn, the external management model appeals to sponsors which are able to maintain management control over assets injected into S-REITs while still pursuing asset-light strategies and unlocking the value of the assets on their balance sheet.

The REIT trustee is typically a licensed third party professional trustee company which acts as a custodian and holds an S-REIT’s assets on behalf of the unitholders.

S-REITs are intended to be passive vehicles that hold predominantly stabilised income-producing real estate and are subject to limits on the amount of leverage and development activities which they can take up. While the market has been dominated by S-REITs investing in traditional asset classes of retail, office, industrial and hospitality, in recent years, more novel asset classes have emerged including data centres and e-commerce facilities.

An alternative structure available for property trusts in Singapore is the business trust (BT), which is essentially a business enterprise set up as a trust structure. Certain property trusts have opted to take the form of a BT due to the greater flexibility afforded to such vehicles. Unlike S-REITs, BTs can actively undertake business operations and are not subject to restrictions on the type of investments or in the manner that their investments are operated. Therefore, where the assets to be listed include a significant amount of assets under development or assets which have yet to stabilise, the BT vehicle would be suitable. The trade-off, however, is that investors tend to perceive BTs as riskier investments and this is factored accordingly into the pricing and performance of the stock.
Other than real estate, BTs have also been used to hold infrastructure and shipping assets. Listed BTs are required to be registered under, and are subject to, the Business Trusts Act. Unlike S-REITs, BTs have a single responsible entity, known as a trustee-manager, which is a Singapore-incorporated private company that is typically owned by the sponsor of the BT.

The Singapore market has also seen stapled structures comprising S-REITs stapled to BTs. This is peculiar to S-REITs holding hospitality assets and was primarily developed due to the highly operational nature of hotels and the inability of S-REITs to hold assets with significant income generated from business operations – the rationale for the stapling is that in the event that the S-REIT is unable to lease out its hotel, the BT, which is able to actively undertake business operations, would step in as a ‘lessee of last resort’ to lease and operate the hotels. Stapled securities must be traded together and cannot be traded separately. Such stapled securities may be advantageous as they can combine the benefits of two different business forms or structures and yet can overcome the restrictions of any particular one. As the S-REIT market matures, there may be more variations of financial instruments involving S-REITs and other structures, signalling a broader investment environment with greater choice for investors.

Apart from S-REITs and property trusts, the Singapore market has its fair share of listed real estate companies. While many of these started off primarily as developers, they have since grown into large integrated real estate players with businesses across the entire real estate value chain from construction and development to ownership, leasing and asset and fund management. Many of the large local real estate companies act as sponsors to S-REITs and own and control REIT managers. With a critical mass of S-REITs now in the market, a large bulk of the real estate M&A activity in Singapore is driven by these vehicles, creating a vibrant market for real estate investment. Real estate companies have benefited from this as well and are able to access a large market of potential buyers for assets and recycle capital efficiently.

ii Real estate PE firms – footprint and structure

Real estate PE fund managers in Singapore are largely made up of the following:

a large local real estate players with fund management platforms and development pipelines, including CapitaLand, Mapletree Investments and Keppel Capital;

b global PE firms, including Blackstone, KKR and PGIM Real Estate; and

c boutique local real estate fund managers.

In its 2017 Singapore Asset Management Survey, the Monetary Authority of Singapore (MAS) estimated that S$101 billion of assets under management in Singapore was invested in real estate (excluding REITs), up by 13 per cent from the previous year.4 Similar to other jurisdictions, real estate PE funds in Singapore follow a range of strategies from core and core-plus to value-add and opportunistic. Unconstrained by the operational restrictions that S-REITs are subject to, real estate PE funds are generally able to close transactions quickly, before stabilising the assets for subsequent sale through upgrading and repositioning activities. The greater flexibility that real estate PE funds possess also allows them to invest in

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non-traditional asset types, including student accommodation, shophouses, medical suites, nursing homes, petrol stations, carparks and dormitories, with transactions in such assets reaching a 10-year high of more than S$1 billion in 2018.5

The structure of real estate PE funds in Singapore often depend on multiple factors including the type and number of investors, the reputation of the fund manager and the intended exit strategy. Small club deals may take the form of simple joint venture structures between a handful of ‘friends and family’ investors with minimal offering-type documentation, while larger fund raisings may see the fund manager hiring investment banks to market the funds through their distribution channels to institutional and high net worth investors.

Fund structures range from more traditional corporate and limited partnership structures but in recent years, trust structures have gained popularity as well, particularly if a potential exit strategy is through a listing of the private trust as an S-REIT or BT. Such a structure could potentially minimise stamp duty compared to a sale of the underlying assets of the fund.

IV TRANSACTIONS

i Legal frameworks and deal structures

S-REITs have traditionally grown inorganically through acquisitions of new assets from both the available pipelines of sponsors as well as from third parties. Given the importance of overseas investments to S-REITs, regulators have been flexible and receptive in permitting S-REITs to adopt the most tax efficient acquisition structures within Singapore’s regulatory regime. As a result, S-REITs now hold their assets through a range of different holding structures depending on the jurisdictions in which the assets are located, including through US REITs, Australian managed investment trusts, Chinese wholly foreign-owned enterprises and Japanese tokutei mokuteki kaisha (TMK) structures. Typically the most important aspect that the Singapore regulators focus on is the ability of the S-REIT to ultimately control the underlying assets and obtain proper legal and good marketable title to the assets.

As S-REITs look to grow and scale up rapidly, there has been an increasing trend of large M&A transactions between S-REITs in recent years. Broadly, REIT M&A transactions have taken the following structures:

- a trust scheme between merging S-REITs;
- a takeover offer for all of the units of an S-REIT;
- the acquisition of an entire portfolio of properties; and
- the acquisition of shares of a REIT manager.

The structure to adopt for a particular transaction is dependent on the ultimate commercial objective, such as whether the intention is for the acquiror to acquire the S-REIT and/or all of its underlying assets or whether it is just to gain control of management. The specific circumstances of the acquiror, for example whether it is already a controlling unitholder of the S-REIT, as well as tax considerations, would also be key factors to consider.

Any M&A or acquisition involving an S-REIT would be subject to the SGX listing rules as well as the Code on Collective Investment Schemes issued by the MAS. Depending

on the size of the transaction and also depending on whether the transaction is between related parties, certain thresholds may be triggered which would require the S-REIT to seek the approval of its unitholders. In the case of related party transactions, the relevant interested persons (including non-independent nominee directors of the REIT manager) would generally need to abstain from voting. To ensure that the interests of minority unitholders are protected, the independent directors of the REIT manager, based on independent valuations and advice from an independent financial adviser, would then make a recommendation that the particular transaction is on normal commercial terms and not prejudicial to minority unitholders. For acquisitions by S-REITs from related parties, the acquisition price generally cannot be above the higher of two independent valuations commissioned for the purposes of the acquisition.

S-REITs are also subject to the Singapore Code on Take-overs and Mergers (Takeover Code). Under the Takeover Code, any person which, together with its concert parties, (1) acquires 30 per cent or more of the units in an S-REIT, or (2) holds at least 30 per cent but not more than 50 per cent of the units in an S-REIT, and which acquires more than 1 per cent of the units in any six-month period, is required to make a mandatory general offer to all the other unitholders.

ii Acquisition agreement terms

Trust schemes

Two recent REIT M&A transactions – the merger between ESR-REIT and Viva Industrial Trust and the ongoing merger between OUE Commercial REIT and OUE Hospitality Trust – have been carried out by way of a trust scheme. In a trust scheme, the acquiring S-REIT acquires all of the units of the target S-REIT in consideration for the issuance of new units in the acquiring S-REIT to the existing unitholders of the target S-REIT. The consideration to the unitholders of the target S-REIT typically also includes a cash component. An application to court to convene a scheme meeting for unitholders of the target S-REIT to approve the trust scheme (of which the threshold for approval is a majority in number of the unitholders representing at least 75 per cent in value of the units held by unitholders present and voting) and the court’s approval for the trust scheme are required to make the trust scheme effective.

A trust scheme is adopted in a friendly transaction, with the parties typically entering into an implementation agreement to agree on the process by which the scheme will be carried out. Warranties would not usually be very extensive given the nature of a trust scheme and the substantial information publicly available on the target. The implementation agreement would also include conditions precedent, which are critical given the significant number of regulatory approvals and other approvals required. Trust schemes may also be implemented in parallel with an acquisition of the target S-REIT’s manager by the manager of the surviving S-REIT.

Takeover offers

While there have not been any takeover bids involving S-REITs to date, there have been property BTs taken private through takeover offers by their respective controlling unitholders. Depending on the interest held by the controlling unitholder, either a voluntary or a mandatory takeover offer may be made by the controlling unitholder to acquire the units from all of the other unitholders. For example, the Nan Fung Group acquired more than 30 per cent of the units in Forterra Trust and triggered the requirement to make a mandatory takeover offer which resulted in the eventual privatisation and delisting of the trust in February 2015.
Another example is the privatisation of Perennial China Retail Trust by Perennial Real Estate Holdings Limited (Perennial), which was done by way of a voluntary offer as Perennial held less than 30 per cent of the units in the trust. The process for a takeover of an S-REIT or property trust, similar to a listed company, is regulated by the Securities Industry Council and is subject to the Takeover Code, which covers, among others, requirements relating to the minimum offer price, the form of consideration, the conditions that can be imposed, the timetable and rules regarding break fee arrangements.

**Portfolio acquisitions**

Portfolio acquisitions are essentially similar to acquisitions of single assets but are larger in scale and usually involve S-REITs acquiring the entire portfolio of assets from PE funds nearing the end of their term and which are looking to exit. As S-REITs have grown, the number of large portfolio acquisitions from PE funds has also been on an increasing trend. In 2018, Ascendas Reit acquired two portfolios of logistics assets in the United Kingdom (UK) for an aggregate of more than £460 million from UK-based PE vehicles. Acquisition of a portfolio allows an S-REIT to gain immediate scale in a particular jurisdiction, sector or asset class. The acquisition terms and structure of portfolio acquisitions would largely be consistent with acquisitions of single assets. Such acquisitions from PE funds that are exiting their investments are also often characterised by the use of warranty and indemnity (W&I) insurance to cover any potential claims by the purchaser. Instead of having funds withheld in escrow or the seller providing contractual indemnities, W&I insurance allows PE fund sellers to have a clean exit of their investments on a fully non-recourse basis and to close their funds after the sale and return all proceeds to their investors.

The S-REIT market has also seen the converse situation where an affiliate of Lone Star Funds acquired the entire portfolio of Saizen REIT in March 2016. An S-REIT would require the approval of SGX and of its unitholders for such a transaction to dispose of its entire portfolio and is therefore likely to be less common given the regulatory uncertainty and protracted timetable that may be required to close.

**Acquisitions of shares of REIT managers**

A cheaper and potentially faster alternative for acquirors looking to gain control of an S-REIT may be to acquire all of the shares of its REIT manager. With the external management model, in practice, the REIT manager is able to effectively control the activities of the S-REIT. The acquisition of the REIT manager is often coupled together with an acquisition of the exiting sponsor’s stake in the S-REIT as well so that the acquirer effectively steps in to replace the outgoing sponsor. Prior to entering into any arrangement where a purchaser would acquire or gain control of an interest of 20 per cent or more in a REIT manager, approval from the MAS must be obtained as REIT managers are regulated and hold a capital markets services licence for REIT management. An acquisition of a REIT manager does not require approval of unitholders of the S-REIT.

### iii Hostile transactions

There have not been any successful hostile takeovers of S-REITs and such attempts remain rare in Singapore. To date, there has only been one instance of such an attempted takeover of an S-REIT which was unsuccessful – in 2017, a number of unitholders of Sabana Shari’ah Compliant Industrial Real Estate Investment REIT successfully requisitioned the REIT
manager to convene an extraordinary general meeting of unitholders to table resolutions to replace the existing REIT manager with an internalised manager wholly owned by the S-REIT, and failing which, to wind up the trust. There was dissatisfaction with the performance of the S-REIT, with falling valuations and acquisitions from the sponsor which were perceived to be at inflated prices, against the backdrop of an earlier dilutive rights issue. The failure to oust the REIT manager may be attributed to several reasons, including:

a  the lack of a credible alternative board and management team. The requisitionists were largely made up of a disparate group of individuals who did not have the resources or the expertise to assemble a team that could lead the proposed internalisation of the manager; and

b  the presence of contractual restrictions and covenants in the financing documents of the trust which would be breached if the existing REIT manager was removed.

While the bid to remove the existing REIT manager was unsuccessful, the incident forced the sponsor to take heed of unitholders’ concerns and following a strategic review by the REIT manager, a number of proposed acquisitions were terminated while there was also a leadership renewal with the chief executive officer and several board members stepping down. With investors becoming more sophisticated and discerning, shareholder activism in Singapore is likely to continue to grow. Hot-button activist issues include conflicts of interests and high management fees.

Competitive takeover offers involving listed real estate companies are also not very common although there had been several high profile deals over the years, including a bidding war that lasted more than six months in 2012 and 2013 between TCC Assets – the investment vehicle of Thai billionaire, Charoen Sirivadhanabhakdi – and Overseas Union Enterprise (now known as OUE Limited) over Fraser and Neave, a then-listed conglomerate with a large real estate business including sponsoring several S-REITs, which was eventually won by TCC Assets. Following this transaction, certain amendments were made to the Takeover Code to codify issues that arose, including implementing an auction process in a competitive bid where a stalemate remains in the later stages of the offer period and a clarification that boards of target companies may, but are not obliged to, solicit competing offers and that such solicitation would not normally be deemed to be frustrating an existing offer. More recently in 2017, a takeover offer led by Yanlord Land and Perennial for United Engineers, a listed real estate conglomerate, was unsuccessful after a minority shareholder, Oxley Holdings, itself a listed developer, amassed a major stake in United Engineers and pushed its stock price above the offer price.

iv  Financing considerations

An S-REIT is subject to an aggregate leverage limit of 45 per cent of its deposited property. As such, REIT managers typically employ an active capital management strategy to find an optimal combination of debt and equity to finance acquisitions. Particularly in the initial years after listing, an S-REIT would often have to undertake equity fund raising which would generally comprise one or more of the following:

a  private placements to certain selected institutional and accredited investors;

b  rights issues which are offerings to all existing unitholders on a pro rata and renounceable basis, (i.e., unitholders may trade their entitlements to purchase new units under the rights issue); and
preferential offerings which are similar to rights issues except that unitholders’ entitlements are non-renounceable and cannot be traded.

Equity fund raising exercises are dilutive to existing unitholders and so it is important for the overall transaction to be yield accretive to unitholders.

For debt financing, S-REITs and real estate companies both have considerable flexibility, with options ranging from obtaining secured or unsecured term loans or revolving credit facilities (whether at the asset or the listed entity level) to tapping the debt capital markets and issuing bonds, convertible instruments and other debt securities. It is not unusual for the terms of debt facilities to contain ‘change of control’ covenants which may require certain key shareholders to maintain a minimum stake in the listed entity. For S-REITs, this also applies in respect of the respective sponsor maintaining ownership of the REIT manager. While practically, this may have the effect of entrenching the REIT manager and the sponsor, the MAS has recognised that such covenants are often important for lenders which want assurance of the identity of the person which controls the S-REIT and such covenants are permitted if required by the lenders and if they are clearly disclosed.

Other than debt securities, S-REITs are also able to issue hybrid securities known as perpetual securities which are not required to be included in the calculation of the 45 per cent aggregate leverage limit, subject to meeting certain conditions, including having a perpetual term, that they can only be redeemed at the sole discretion of the S-REIT, distributions on such securities are non-cumulative, there is no step-up in the coupon and they are deeply subordinated.

As financing by an S-REIT usually requires the public equity and/or debt markets to be accessed, it is not uncommon for there to be financing conditions in an acquisition. This is where real estate PE funds may have a competitive advantage as they would typically not require a ‘financing out’ and would be able to provide greater deal certainty for a seller. PE funds and real estate companies are generally not subject to regulatory leverage limits although they would need to maintain agreed loan-to-value (LTV) ratios which are commercially negotiated with their lenders in their financing agreements. LTV ratios vary depending on the underlying asset; for commercial real estate, they typically range from 60 per cent to 70 per cent.

v Tax considerations
To promote the listing of S-REITs and to strengthen Singapore’s position as a REIT hub in Asia, the Singapore government has, over the years, granted several tax concessions for S-REITs.

Tax transparency (in the context of an S-REIT) refers to an arrangement where the specified income of an S-REIT is not taxed in the hands of the REIT trustee, but in the hands of the unitholders (whether by withholding or otherwise) unless exempted. S-REITs can benefit from tax transparency subject to certain conditions, including a requirement that the REIT trustee distributes at least 90 per cent of its specified income to unitholders. A significant advantage of investing in an S-REIT is that individual unitholders can enjoy full tax exemption on specified income earned by the S-REIT. In addition, foreign

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6 In the Budget Statement for Financial Year 2019 (2019 Budget), it was announced that this exemption would no longer be subject to a sunset clause and would be granted on a permanent basis going forward.
non-individual unitholders will only be subject to a final withholding tax at the rate of 10 per cent on specified income distributed by the S-REIT. Recognising the prevalence of S-REITs investing in assets overseas, tax exemption has also been granted over foreign-sourced income received by S-REITs, that is paid out of qualifying income or gains in respect of overseas properties acquired on or before 31 December 2025 by a REIT trustee.

The tax transparency treatment for S-REITs does not extend to gains realised from the sale of real properties. There is no capital gains tax in Singapore, and gains realised on a disposal of an S-REIT’s real properties would be subject to income tax at the prevailing corporate tax rate if they are considered to be trading gains. The REIT trustee will then be liable to pay the tax so assessed. Whether a gain realised from the disposal of real property is deemed a capital gain or a trading gain will be determined based on the circumstances of the transaction.

Buyer’s stamp duty (BSD) is payable on transfers of real estate on the execution of the sale and purchase agreement. Currently, BSD is payable by a buyer on a transfer of property, and different rates of BSD apply depending on the type of property transferred. BSD is based on the higher of the purchase price and market value of the property. BSD is normally payable by the buyer of the property, unless otherwise agreed between the parties. For industrial properties, Seller’s stamp duty is also payable by a seller on a transfer of industrial property purchased on and after 12 January 2013, and sold within three years from the date of purchase.

S-REITs typically will hold Singapore properties directly rather than through a corporate entity to enjoy full tax transparency on the rental income without paying any corporate income tax. Where tax transparency is not applicable, real estate companies and PE funds can also hold Singapore properties through Singapore corporates. Acquisitions of shares of a Singapore company is subject to stamp duty at 0.2 per cent of the higher of the purchase price or the value of the shares.

For acquisitions of residential properties or interests in property-holding entities that own primarily residential properties in Singapore, additional stamp duties on both buyers and sellers will apply.

vi Cross-border complications and solutions

There are no foreign investment restrictions on non-residential properties and the ease of investment remains a key attraction for the Singapore corporate real estate market.

Similarly, outbound investment is important for the continued growth of S-REITs and local PE funds which have proven adept at navigating cross-border transactions. When acquiring assets in a new jurisdiction for the first time, REIT and fund managers need to understand not just the local market, but also the local real estate and tax laws and local counsels will need to be engaged to conduct due diligence and advise on local laws. For S-REITs in particular, it is critical from a regulatory perspective to ascertain whether the S-REIT can acquire proper legal and good marketable title to the property or the local equivalent.

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7 In the 2019 Budget, it was announced that this exemption would be extended until 31 December 2025. It was originally scheduled to lapse after 31 March 2020.

8 In the 2019 Budget, it was announced that this exemption would be extended until 31 December 2025. It was originally scheduled to lapse after 31 March 2020.
For Singapore residential properties, foreign developers need to apply for a qualifying certificate under the Residential Property Act, which stipulates certain conditions such as timelines for completion of the construction works and sale of the developed units, before they can acquire restricted residential properties for redevelopment.

V CORPORATE REAL ESTATE

The establishment of S-REITs as well as (in the case of local real estate companies) PE funds has been fuelled by corporates undertaking asset-light strategies and spinning off assets on their balance sheets into S-REITs or PE funds. With the external management model, real estate companies have maintained control over these assets by building up large REIT and fund management platforms which may support and manage multiple S-REITs and PE funds. For the large local developers, establishing both S-REIT and fund platforms allows them to tap different sources of capital from a wide spectrum of investors by offering a range of securitised real estate products with different risks and returns. A typical structure would see the developer inject developing or non-stabilised assets into development or incubator funds before being sold to an S-REIT once stabilised.

In addition, particularly with industrial, logistics and hospitality companies and data centre operators, injecting their real estate assets into S-REITs or PE funds and putting in place sale and leaseback arrangements have allowed them to realise value from their properties while retaining operational control. In one of the largest industrial deals, and the largest single-asset industrial transaction, in Singapore in 2018, LOGOS Property Group, a privately held logistics property specialist, acquired a 25 hectare industrial site in Tuas South in a sale and leaseback transaction with REC, a global solar firm which is part of the Bluestar Elkem group. As part of the transaction, the integrated industrial and warehouse facility situated on the site, which houses REC’s entire manufacturing chain for the production of solar panels, was leased back to REC on a long term lease, allowing REC to unlock capital and strengthen its balance sheet, while continuing to meet its operational requirements.

VI OUTLOOK

Increased US trade protectionism, a slowdown in China’s economy and ongoing trade tensions between the US and China have fuelled macroeconomic uncertainties and volatilities in the stock market, with many S-REITs and property trusts trading at discounts to NAV. This may present opportunities for PE funds and other real estate players to make opportunistic acquisitions from the public markets. Singapore was ranked the second best real estate market in Asia-Pacific for investment in 2019, and is likely to continue to see a vibrant real estate M&A market with active participation among both private equity and public listed entities.

Despite market volatility, investor appetite for defensive investments should still remain strong and S-REITs and property trusts, being commonly perceived as safe havens, are positioned to perform relatively better than the general market. With two new S-REIT
listings to date this year, there still remains investor appetite and a healthy pipeline of S-REIT IPOs with a focus on cross-border assets, but finding the right timing to market will be a critical factor amidst the economic and political headwinds.

As the S-REIT market matures, the trend of real estate M&A and consolidation activity is poised to grow further as businesses look to scale up quickly and acquire accretive assets at attractive valuations as well as to achieve better synergy.

10 As at June 2019.
I  OVERVIEW OF THE MARKET

Throughout 2018 and at the beginning of 2019 the investment model that has defined the Spanish real estate market (particularly after the beginning of the deep economic recession suffered in Spain from 2008) has been consolidated. In this regard, during the past few years the main transactions of the Spanish real estate sector have been led by the following players: (1) investment funds (from vulture funds to core funds); (2) the SOCIMIs (listed investment trust companies, as in the Spanish version of REITs); (3) the SAREB (the Spanish ‘bad bank’), which has been quite active recently in the transfer of non-performing loans; (4) financial institutions that accumulate in their balance sheets considerable real estate assets and non-performing loans secured by mortgages; and (5) qualified family offices.

The transaction volume continued its upward trend during 2018 and the beginning of 2019, bolstered by steady economic and employment growth in Spain, although perhaps the investor appetite plateaued in the months prior to the national and autonomic elections from April to the end of May due to political uncertainty.

Once again, as in previous years, foreign investment is a key factor in the Spanish real estate market. According to recent data, the foreign investment in Spain amounts to approximately €15.2 billion in 2018, which represents 1.26 per cent of the Spanish GDP. Likewise, the same studies indicate that Spain was the fifth country in terms of international investment volume in 2018, only surpassed by the United States, the United Kingdom, Germany and France. By regions, the main destinations of core profile investors are the cities of Madrid and Barcelona, which have been particularly active in the office, retail and residential segments. Diversification is perhaps the key word to define the strategy of international investors.

Particular mention should be made of the relevance of the hotel sector during 2018. This sector has become not only one of the main driving forces of the Spanish economy, but also one of the sectors that concentrates a large part of foreign investment. According to recent studies, the hotel investment in Spain amounted to €4.8 billion in 2018, 35 per cent more than the previous year. Important transactions were closed during this year, such as...
as the acquisition of Hispania by Blackstone (whose hotel portfolio was estimated to be €1.7 billion) or the acquisition of Hotel Villa Magna (an emblematic hotel located in Paseo de la Castellana, in the financial centre of Madrid) by the Mexican group RLH Properties for €210 million.

The logistics sector has also been an important focus of investment in recent years, especially in 2018, due to the pull of e-commerce. Companies of the size of Airbus or Amazon have boosted this branch of the real estate sector, reinforcing their logistics in Spain with the opening of new centres. Following this trend, the logistics market closed 2018 with an investment of €1.2 billion, according to data from Savills Aguirre Newman. On the other hand, between January and March 2019 it is estimated that the total investment in the logistics market in Spain reached the figure of €206 million. The most outstanding transaction throughout this period has been the sale of five industrial warehouses located in different cities of Spain by Kefren Capital Real Estate, Brunswick Real Estate and Grosvenor Group, and acquired by Prologis and Blackstone for an amount of €57 million.

Finally, driven by socio-demographic evolution and social needs, in recent times there has been greater interest on the part of investors in alternative sectors, such as student residences or geriatric centres, which often involve more stable investment and economic counter-cyclicals. The profile of this type of operation tends to respond to the tandem composed by foreign institutional investors and large operators with experience in the sector. In this segment, corporate purchases often take precedence over direct asset deals.

II RECENT MARKET ACTIVITY

i M&A transactions

The Spanish real estate market has been quite active in terms of M&A transactions during 2018 and 2019, continuing on the path of large transactions concluded in previous years.

One of the main transactions concluded in 2018 was the sale of 80 per cent of the real estate business of Caixabank to a corporate vehicle owned by Lone Star for €5.6 billion, which is ranked in the top ten of corporate real estate transactions of the year.

In the stock market, the leading hospitality, restaurant and lifestyle operator Minor International successfully executed the public takeover bid (OPA) on NH Hotel Group (listed on the Madrid Stock Exchange), gaining control of 94.14 per cent of the Spanish hotel company. The bid launched by Minor, through MHG Continental Holding, was valued at around €2.5 billion.

Regarding the performance of the SOCIMIs during 2018, it should be highlighted the public takeover bid (OPA) launched by Blackstone over Hispania, valued at €1.993 billion, through which the private equity firm acquired 97.9 per cent of the entity. With this transaction, Blackstone, in addition to becoming the leading hotel owner in the country, also strengthened its position as the first owner of real estate assets in Spain.

7 Source: Snapshot Logística 1er Trimestre 2019, Knight Frank.
8 Source: 2019 Real Estate M&A Outlook, Deloitte.
ii Private equity transactions

The Spanish private equity market has grown considerably as a result of the country’s solid economic growth. Although the international funds are interested in a large number of sectors, they have focused their investments around the real estate market, which has been the centre of many relevant and sophisticated transactions.

The most important transaction executed by an international fund was the acquisition of 51 per cent of two real estate portfolios of Banco Sabadell by Cerberus for a total amount of €3.9 billion.

On the other hand, Blackstone, in addition to Hispania’s acquisition referred to above, participated in another important transaction in the Spanish market: the acquisition of Testa, a leading company in the residential rental sector in Spain. The private equity firm, through its company Tropic Real Estate Holding, concluded the taking of control of the company in April 2019 through the acquisition of the shares of Santander, BBVA and Merlin Properties, holding a participation share equal to 99.52 per cent of the share capital of the entity. Testa, listed since July 2018 in the MAB, has a portfolio of assets higher than the 10,700 dwellings that gave the company a capitalisation of €1.833 billion when joining the stock market.

Finally, Värde Partners carried out one of the most important transactions in the real estate development sector with the merger of Vía Célere and Aelca, companies controlled by the international fund. The corporate transaction implied the transfer of all the residential assets of Aelca in Vía Célere and had to be approved by the Spanish competition authority (CNMC). After integrating all the assets of Aelca, Vía Célere will have the capacity to deliver an estimated 2,000 dwellings in 2019 and 5,000 dwellings in 2021, being the greater residential developer company in Spain. Värde will own 75 per cent of Vía Célere’s share capital, while the rest of minority shareholders (Marathon, Attestor, BAML, Barclays, DB and JPM) will own the remaining 25 per cent.

III REAL ESTATE COMPANIES AND FIRMS

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

SOCIMIs have recently become one of the main driving factors of the Spanish real estate sector. This legal vehicle is directly inspired by American REITs, whose success and subsequent expansion to other jurisdictions has been undeniable.

Taking these corporate entities as a model, the Spanish legislator decided to incorporate into our law in 2009 (Act 11/2009) a type of listed company comparable, in essence, to the REIT. After a somewhat hesitant start, the in-depth legal reforms introduced in 2012 have been a real boost for SOCIMIs, in such a way that they are attractive to investors. At present, the legal regime of SOCIMIs is characterised as one of the most modern and flexible in Europe.

The main characteristics of the legal regime of the SOCIMIs can be summarised as follows:

- SOCIMIs must necessarily have the legal form of a public limited company.
- The minimum share capital of the SOCIMIs is €5 million.
- In general terms, the main activity of the SOCIMIs involves the acquisition, promotion and refurbishment of urban real estate assets for their leasing, as well as the participation in the share capital of certain kind of companies (mainly, other SOCIMIs).
- SOCIMIs shall invest 80 per cent of the value of their assets in the following types of goods: (1) real estate assets of urban nature intended for leasing; (2) lands for the
real estate promotion, provided that the promotion begins within three years after the acquisition of said lands; and (3) in the share capital or equity of the corporate entities referred to in Article 2.1 of Act 11/2009.

e SOCIMIs are listed companies which must be admitted to trading on a regulated market (subject to greater regulatory requirements) or in a multilateral trading facility (whose regulation is much more flexible). Most of the SOCIMIs are listed on the Alternative Stock Market (MAB), where there is a specific segment for this type of entities.

f SOCIMIs that intend to be listed on the MAB must comply with additional requirements. Although a minimum number of stockholders is not established, it is necessary to comply with a minimum free float at the time of incorporation into the MAB.

The main attraction of SOCIMIs for investors derives from the possibility of enjoying a special tax regime and from the conditions for distribution of profits:

a SOCIMIs shall distribute dividends out of the profits obtained each year (after mandatory company law allocations) equivalent to: (1) 100 per cent of the profits arising from qualifying equity investments; (2) 50 per cent of the gains obtained from the disposal of real estate, subject to special rules; and (3) 80 per cent of all other profits. The dividend distribution must be resolved within six months after the end of each financial year.

b SOCIMIs may opt for the application of a special tax regime. In this regard, although the SOCIMIs are subject to the Corporate Income Tax, they will benefit from a tax rate of 0 per cent, provided that shareholders owning at least 5 per cent of the SOCIMI are taxed on the dividends received at a minimum rate of 10 per cent. Likewise, where investors in the SOCIMI do not meet the abovementioned requirement, the SOCIMI will be taxed at 19 per cent on the portion of the distributed profits corresponding to those investors.

The standard stock market for the SOCIMIs, as stated above, is the MAB, where 17 new SOCIMIs were incorporated during 2018. In all, the new listed SOCIMIs manage around €4.5 billion in real estate assets. It should also be noted that in 2018 there was the first takeover bid (OPA) between SOCIMIs in the MAB, led by Vitruvio and Única, a trend that is expected to continue in the future with the consolidation of this market.

ii Real estate PE firms – footprint and structure

Most real estate PE firms in Spain have a foreign component. In this regard, it should be highlighted the success and importance of international investment funds such as Blackstone, Cerberus, Lone Star or Apollo. Among the abovementioned firms, Blackstone is probably the most relevant PE firm which operates in Spain, participating in leading transactions in the last years, as referred to above.

IV TRANSACTIONS

i Legal frameworks and deal structures

In general, there are two typical structures for the acquisition of real estate assets in Spain: (1) the direct acquisition of the real property (asset deal); or (2) the indirect acquisition of
the real property by means of the purchase of the shares of the company owner of said real property (share deal). Although the objective pursued is identical, the legal regime of these investment strategies is logically different.

**Asset deals**

Direct investment through an asset deal is unquestionably the most common way of acquisition of a real estate asset in Spain. Spanish private investors and Family Offices prefer, without a doubt, this type of deal.

When the investor is a foreign company, it is also quite usual that the investment is executed by a Spanish SPV owned directly or indirectly by the foreign company (and typically, through a company with registered office in Luxemburg or the Netherlands).

Regarding the legal framework, in Spain there is a principle of freedom of agreement between the contracting parties, which implies that all the agreements concluded between the parties are valid provided that they do not infringe any imperative law, the moral rules or the Spanish public order. Additionally, the general rule is to grant a public deed since only the notarised document can be recorded in the Land Registry.

Despite this, it is possible to grant just a notarial public deed to acquire a property in Spain (notwithstanding a previous LOI, NBO or BO), and it is quite common to execute a private sale agreement before granting the public deed. In any case, it is not mandatory, and possibly it would be better, for the sake of the safety, to grant the notarial deed directly. The public deed would include standard representations and warranties for both parties. The Spanish Civil Code provides a significant degree of protection to the buyer, since the seller is legally liable for: (1) the non-existence of title or the third party preferential rights on the property, or title risk; and (2) any hidden defects in the property. Exclusion of this legal regime requires some specifics waivers in the deed. It is also quite common to extend or reduce the legal periods in which the buyer may require protection from the seller after the acquisition.

It is not customary in Spain to subscribe an insurance policy to cover this kind of risk. The legal system provides investors with safe conditions in which to conduct business. Once the public deed has been granted, the buyer may record the ownership in the Land Registry. Although registration is not mandatory, the general rule is to register the title in the Land Registry in order to enforce the ownership against third parties.

**Share deals**

Acquisition of a real estate asset may also take place indirectly through the purchase of shares of the company that owns said asset. The complexity of this kind of transaction is usually higher, since the acquisition of the company does not only imply the acquisition of the property but the acquisition of a business. As a consequence of this, the due diligence process is logically more complicated and generally involves different areas of the Law that are not directly linked to the property, such as corporate matters, tax issues, data protection or, eventually, employment matters.

Regarding the formalities when acquiring shares, these depend on the type of company and the type of shares. When the target company is a limited liability company, the shares (quotas) shall be transferred by virtue of a public deed (as stated in Article 106 of the Corporate Enterprises Act) and will require the subsequent communication to the administrative body
of the company in such a way that the new shareholder appears in the company’s shareholder book. When the target company is a public limited company, the transfer of the shares can also be done via security broker or endorsement.

In the share deals, it is particularly important to check the by-laws of the company in order to analyse whether there is any restriction on the transfer of shares (or quotas) that might impede the transaction. If there is no mention included in the by-laws, the buyer shall take into account that according to the Law the shareholders of a limited liability company have pre-emption and preferential purchase rights in the transfer of shares by other shareholders. Additionally, it is also advisable to analyse the existence of shareholders agreements, when the company is participated by two or more shareholders, since some limitations or restrictions on the transfer of shares may derive from this kind of agreement, which usually include provisions that are not fully coordinated with the by-laws or that goes beyond what is permitted to include in them.

On the other hand, the buyer should review the existence of any change of control clauses in agreements subscribed by the target company. These type of clauses would entitle the other party to early terminate the agreement (or amend its terms and conditions) if there is a relevant change in the corporate structure of the other party.

Finally, once the transaction has been executed there are some additional steps from a legal perspective in order to continue with the business of the company. Thus, it may be necessary to remove the former directors of the company and to appoint new directors. This change usually implies the amendment of the structure of the administrative body (for instance, from a sole director to a board of directors). Likewise, the buyer should grant new powers of attorney and revoke the former powers granted by the Company. Sometimes it is also necessary to amend the by-laws in order to adapt them to the new corporate reality.

ii Acquisition agreement terms

The terms of the agreement by means of which the buyer will become the new owner of the asset or the new owner or co-owner of the company which holds the real property differ logically depending on the nature and complexity of the transaction. However, in general terms there are three clauses that are crucial for the success of the transaction.

Subject matter of the agreement

Although it may be obvious, it is fundamental to clearly state and define the scope of the transaction. In an asset deal the goal of the buyer is undoubtedly the acquisition of the relevant asset. In a share deal the main goal of the buyer is to acquire all the shares of the company (or a majority portion of them) which owns the real estate asset. However, it must be clear in the SPA that the purpose of the buyer is not only the purchase of shares, but the indirect acquisition of a real estate asset. In this case, it is common practice to refer to a schedule which includes the exact details of the real estate asset.

Representations and warranties

Inspired by the Anglo-Saxon practice, most acquisition agreements (for both asset deals and share deals) contain a long list of representations and warranties, despite this not being common practice according to the Spanish Civil Code. The results of the due diligence will have an impact on the representations and warranties requested by the buyer. Standard representations and warranties include the following categories:
ownership of the shares/assets;
incorporation, capacity, by-laws and absence of shareholders’ agreements, managing bodies, powers, auditors (applicable to share deals);
financial statements and books of account (applicable to share deals);
taxation and social security compliance (applicable to share deals);
validity of the main agreements concluded by the company (applicable to share deals) or the agreements affecting the property, mainly lease agreements (applicable to assets deals);
insurance (applicable to both share deals and asset deals);
employment matters (applicable to share deals, or eventually to asset deals);
licences, authorisations and environmental (applicable to both options);
lawsuit (applicable to both share deals and asset deals); and
data protection (applicable to both share deals and asset deals involving a certain kind of asset, such as hotels or buildings with security video cameras).

Indemnification and security

By means of the indemnification clause the seller undertakes to hold the buyer harmless from any contingency derived from the misrepresentation of the seller when granting the representations and warranties, during a period of time.

In any case, and as we said before, the Spanish legal system regarding real estate transactions is quite safe, and the Property Registry normally offers accurate information to any buyer. Also, these transactions can be protected by the close collaboration between the Notary and the Land Registry regulated by Law, avoiding a scenario where property is (re)sold, mortgaged or seized before its acquisition.

iii Hostile transactions

As stated in in the previous editions of The Real Estate M&A and Private Equity Review, the Spanish real estate market is quite predictable for its participants and therefore no hostile transactions have occurred during the last year.

iv Financing considerations

There are different possibilities for financing a real estate transaction. The traditional way of obtaining funds is by means of a bank loan and the subsequent mortgage of the property. However, it is also typical for the buyer to opt for a combination of equity or intra-group loans and debt (aforementioned bank loans).

Most common clauses included in financing agreements related to real estate transactions are the following:
cross-default with any other agreements granted by the bank entity;
the borrower shall obtain the prior authorisation of the bank entity in order to transfer the property;
the hiring of insurance in order to secure the property;
the obligation to regularly submit documentation to the bank entity related to the company (mainly, financial statements and the audited annual accounts) or to the property in itself (for instance, the leases agreements concluded);
the borrower shall not be entitled to request additional financing from other entities without the prior consent of the bank; and
the bank reserves the right to transfer the loan without requesting the prior approval of the borrower.

Finally, it should be noted that for share deals, Spanish law has a general prohibition on the provision of financial assistance, which implies that both public limited liability companies and limited liability companies are generally prevented from granting financial assistance to a third party for the acquisition of its own shares, including granting warranties or using their assets as collateral.

v Tax considerations
As stated above, real estate investment can be executed either by an asset deal or by a share deal. In this regard, sometimes the choice between these two forms of investment relies exclusively on tax reasons.

**Taxation on asset deals**
On the one hand, the acquisition of a property is subject to the payment of either of the following taxes: the VAT or the transfer tax. As a general rule, the first transfer of non-residential properties (from developer to client) is subject to VAT at a rate of 21 per cent, as the first transfer (from developer to client) of residential properties is subject to VAT at a rate of 10 per cent. Likewise, second and subsequent transfers of properties (any seller to any buyer) are exempt from VAT and subject to the Transfer tax at a rate of 6 per cent to 11 per cent (depending on the region where the property is located), unless the buyer is a VAT taxpayer entitled to enjoy a full or partial deduction of VAT, in which case the buyer can expect the exemption from VAT by means of the corresponding statement in the public deed. In this regard, even if the buyer discards the VAT exemption, the buyer can deduct this VAT at the same moment of granting the deed, so it would be just a formal statement in the deed without having to pay the VAT to the seller.

On the other hand, the buyer must also take into account that public deed granted for the acquisition of assets are subject to the stamp duty at a rate of 0.5 per cent to 2.5 per cent depending on the location of the property and the transactions executed.

**Taxation on share deals**
The share deals are exempt from the Transfer tax and from VAT. However, there is an exemption established in Article 314 of the Consolidated text of the Securities Market Act when the transfer of the shares is executed with the purposes of avoiding the payment of the Transfer tax or the VAT that would have been paid in the event of transfer of the property. Thus, this article presumes that there are tax avoidance reason when at least 50 per cent of the assets transferred are real estate assets located in Spain which are not allocated to business activities (it is allocated for business activities, for instance, a hotel, a petrol stations or an leased office), provided that the buyer acquires control (or increases its control) over the company owner of such real estate assets. The legal consequence of the application of this article is that the transaction will be subject the Transfer tax (at a rate of 6 per cent to 11 per cent) or to VAT (at a rate of 21 per cent or 10 per cent).
vi Cross-border complications and solutions

There are no restrictions for foreign investment in Spain. However, the investors should take note of three issues when executing an asset deal or a share deal.

First of all, when the foreign investor performs before a Spanish public notary, it is necessary to declare the current corporate structure of the foreign company since the notary must comply with the provisions of the Act 10/2010, on prevention of the money laundering.

Secondly, from a tax perspective, investors should analyse whether there is any double taxation treaty between Spain and their countries that may mitigate the impact of the transaction.

Finally, the foreign companies which invest in Spanish non-listed companies must file the standard D-1A form (only for statistical purposes and to prevent fraud or money laundering). The deadline for filing the statements is one month from the completion of the investment.

V CORPORATE REAL ESTATE

The corporate structure used for the acquisition of a real estate asset mainly depends on two factors: (1) how the future real estate acquisition will be developed, and (2) the way of disinvestment planned by the investor.

Although there is no single structure, a normal one might involve the incorporation of a Spanish property company (propco) in order to acquire the asset or the company which owns the asset. The propco would be the subsidiary company of a holding company (holdco), located depending on the nationality of the investor. In any case, tax and legal issues would have to take into account to decide the best structure.

On the other hand, a particular mention should be made to a specific structure used in the development of lands. In recent years, joint ventures between landowners and developers or private investors (in particular, foreign funds) have been increasingly used as an investment structure. The landowner and the developer or the investor would jointly participate in a company in which the landowner would have or would put the land. The normal scenario is that the investor provides financial liquidity to the project and the developer would provide know-how and activity.

In addition, there are different forms of remuneration for the acquisition of land and the former landowner may be remunerated by means of an exchange of land for future finished construction (mostly in the residential sector), by means of which the former landowner will obtain future units (e.g., dwellings or premises) in exchange.

VI OUTLOOK

The performance of real estate players in 2018 and Q1 of 2019 predicts a favourable scenario for the rest of 2019. In particular, foreign investments will probably continue to lead the market, executing relevant transactions during the year.

The announcement of the release of large portfolios suggests that the volume of investment will remain high. Among others, the sale of a portfolio of properties owned by El Corte Inglés (the biggest distribution group in Spain) has been reported for this year, valued at more than €1.5 billion.
Another trend will be the sale of non-strategic assets by SOCIMIs and international funds. In this regard, Blackstone has started this process with the sale of office assets owned by Hispania.

Regarding sectors of activity, the hotel sector will probably be one of the main drivers of the Spanish economy as well as a clear target for international investors, although it will be difficult to achieve the investment volumes registered in previous years. However, some private equity firms could sell some hotel portfolios once they have concluded the repositioning strategy of these assets. Alternative sectors, such as student residences or geriatric centres would continue on the focus of the investors.

Finally, 2019 will also be a turning point for the implementation of new technologies, big data and robotisation in the real estate market. New technologies have drastically transformed the business models of almost all sectors of activities, including banking, insurance or wealth management. The union of the new technologies with these sectors of activity have created the so-called fintech, insurtech or wealthtech, which have stirred these industries. The real estate sector is not immune to this phenomenon and proptech is a reality which will modify rules of the market. Companies increasingly demand higher quality spaces and implement new forms of work that promote employee flexibility and productivity. In this regard, flexible space will be an important bet for many companies, which will introduce new international players (other than Regus or WeWork, which are already present in Spain) to the Spanish market, in order to provide these services.
I OVERVIEW OF THE MARKET

The Swiss economy provided fertile ground for M&A activity in 2018, with a record-breaking 493 transactions reported over the course of the year. The transaction volume amounted to US$132.9 billion. Private equity is playing an increasingly important role in company M&A. Private equity deals peaked at 160 transactions in 2018 with a transaction volume of US$35.6 billion in 2018, which is 96.7 per cent higher than in the previous year.¹

Consistent with the past, the clearly prevailing majority of real estate transactions for both commercial and residential properties in Switzerland is still in the small to medium volume range and larger portfolio transactions are still the exception from the rule in Switzerland.² Due to the continuing low interest rates, real estate investments in Switzerland have generally remained attractive in recent years and no significant change for the near future is expected in this regard. However, while market prices for real estate investments are continuing to increase as a reflection of the continuing attractiveness of the asset class, rent levels have overall remained rather flat in Switzerland meaning that yield levels for institutional investors have come under some pressure compared to previous years. The vast majority of real estate transactions still reflect traditional models and there is not noticeable major shift towards corporate and Wall Street-oriented investment and transaction models.

II RECENT MARKET ACTIVITY

i M&A transactions

Below is a summary of three of the most significant real estate M&A transactions in the Swiss market of the last years.⁴

Acquisition of 93 per cent stake in SSN GROUP AG by CONSUS Real Estate AG

In Q4 2018, the Germany-based and listed real estate company CONSUS Real Estate AG acquired a 93 per cent stake in Switzerland-based SSN GROUP AG against cash as well as newly issued shares of CONSENSUS Real Estate AG for a total purchase price of €470 million. The transaction increased CONSUS Real Estate AG’s real estate development volume from €6.2 to €9.6 billion and the number of projects from 53 to 65.⁵

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¹ KPMG, Clarity on Mergers & Acquisitions 2018 and 2019.
Switzerland

Acquisition of 100 per cent-stake in Immobiliengesellschaft Fadmatt AG by Mobimo Holding AG

In Q3 2018, the Switzerland-based and listed Mobimo Holding AG acquired a 100 per cent stake in Immobiliengesellschaft Fadmatt AG by way of a friendly takeover offer to all shareholders of Immobiliengesellschaft Fadmatt AG. The purchase price of 183 million Swiss francs was paid in cash (almost 50 per cent) as well as in 383,377 newly created shares. The real estate portfolio of Immobiliengesellschaft Fadmatt AG contained 503 apartments spread over seven locations in the cantons of Zurich and Schaffhausen and had a total value of around 289 million Swiss francs. After consummation of the transaction, the portfolio was fully integrated into the Mobimo Group.

Acquisition of majority stake in PAX-Anlage AG by Basler Leben AG

In Q1 2017, Switzerland-based Basler Leben AG, a 100 per cent-subsidiary of the listed Bâloise Holding AG, published a takeover offer to buy all shares in listed PAX Anlage AG (now ARTIRES AG) for a purchase price of 1,600 Swiss francs per share (i.e., a maximum purchase price of 288 million Swiss francs). After consummation of the transaction, Basler Leben AG has held a total of 84.14 per cent in PAX Anlage AG.

ii Private equity transactions

Although publicly available information about real estate PE transactions in Switzerland is still limited, below are two real estate transactions that are representative of corporate real estate investments in recent years:

Acquisition of a portfolio from StenProp by Helvetica Property Investors

In Q3 2018, Helvetica Property Investors bought a portfolio consisting of seven properties from StenProp for a purchase price of US$103.8 million. Two properties were sold as part of a share deal, while the remaining five were sold as asset deals.

Acquisition of a single asset from an unidentified seller by Rockspring Property Investment Managers

In Q1 2016, Rockspring Property Investment Managers bought l’Atelier, a ground-up office development project in Geneva from a local private investor for a purchase price of US$89.24 million. Details on the deal terms are unknown.

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7 https://www.mobimo.ch/de/medien/medienmitteilungen/1752683.
9 Preqin RE deal information.
10 https://www.cbre.ch/de-ch/uber-cbre/media-centre/stenprop.
11 Preqin RE deal information.
III REAL ESTATE COMPANIES AND FIRMS

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

The main types of publicly traded real estate investment vehicles in Switzerland are listed real estate funds and listed real estate companies. The structure of real estate investment trusts (REITs) has so far not been introduced into Swiss law. However, the contractual real estate fund (see below), whose shares can be listed on a stock exchange, constitutes a form similar to REITs. Furthermore, the distribution of foreign REITs in Switzerland may be subject to restrictions and regulatory requirements.

Real estate funds

Listed real estate funds are becoming increasingly popular in Switzerland and appear either in the form of a contractual investment fund (Article 25 CISA) or an investment company with variable capital (SICAV, Article 36 et seq. of the Collective Investment Schemes Act, CISA). They most often acquire their properties by way of asset deals, as opposed to acquiring shares of real estate companies.12 According to information published by FINMA,13 there are currently 66 real estate funds authorised by FINMA, of which five are structured in the form of a SICAV and 61 in the form of a contractual investment fund.

Contractual investment funds do not constitute legal entities but are structured based on a collective investment agreement (fund contract). Under such fund contract, a fund management company (which must be a company limited by shares with registered office and main administrative office in Switzerland) commits itself to involving investors in accordance with the number and type of units which they have acquired in the fund and managing the fund’s assets in accordance with the provisions of the fund contract. The fund management company manages the fund at its own discretion and in its own name but for the account of the investors. SICAVs, on the other hand, are in principle established pursuant to the provisions of the Swiss Code of Obligations (CO) for the formation of companies limited by shares (with certain exceptions). Their capital is divided into company shares and investor shares. Unless the law and articles of association provide otherwise, a SICAV may at any time issue new shares at the net asset value and must, if requested by a shareholder, at any time redeem issued shares at the net asset value (open-ended structure). SICAVs are only allowed to operate in the Swiss market once an authorisation has been obtained by the Swiss Financial Market Supervisory Authority (FINMA).

Real estate companies

Listed real estate companies in Switzerland are non-regulated companies limited by shares (according to the CO) and can be classified into real estate investment companies and real estate operating companies (REOCs). Real estate investment companies’ sole purpose is the collective investment of capital with the purpose of generating income and/or capital gains and without any entrepreneurial activity. Listed REOCs, on the other hand, qualify as such if at least two-thirds of their sustainable income comes from real estate activities, i.e. rental income, valuation or sales success and other real estate services (e.g., property valuation, property management and property development).14 The SXI Real Estate index (an index

14 SIX regulations.
that considers real estate shares with a listing on SIX Swiss Exchange) currently contains 16 REOCs.\textsuperscript{15} Listed real estate companies are excluded from the scope and regulatory requirements of the CISA due to their stock exchange listing.

The largest listed real estate companies in Switzerland hold between 50 and 190 real properties. Due to falling prices for retail spaces, they have recently focused their investments on the office and residential sectors.

\textbf{ii} \hspace{1em} \textbf{Real estate PE firms – footprint and structure}

National and international investors typically use one of the following investment vehicles for real estate private equity investments in Switzerland:\textsuperscript{16}

\begin{itemize}
\item[a] Foreign investment vehicles in any form, often a Luxembourg fund structure, for example in the form of corporations, specialised investment funds (SIFs) or investment companies in risk capital (SICARs);
\item[b] Real estate companies, usually in the form of a stock corporation;
\item[c] Limited partnership for collective investments (KGK) pursuant to CISA (which can be described as the Swiss version of the limited liability partnership known in Anglo-Saxon countries).
\end{itemize}

Real estate companies are probably the most frequently chosen investment vehicles for real estate private equity investments. Since its establishment in 2007, the KGK as Swiss alternative to foreign limited liability partnerships has only had moderate success. According to information published by FINMA, there are currently 19 approved KGK, of which only seven are focussing on real estate investments.\textsuperscript{17} Furthermore, most of such KGK seem to be single asset real estate funds.

The two open-ended collective investment schemes provided by the CISA, the contractual investment fund and the SICAV (see above), are less suitable for private equity real estate investments. In particular, they are inappropriate because of their open-ended structures (i.e., the investors’ right to redeem their units or shares at the net asset value and at the expense of the collective assets) which is contrary to a typical private equity investment, where the funds are invested over a longer period in an illiquid real estate project.

\section*{IV \hspace{1em} TRANSACTIONS}

\textbf{i} \hspace{1em} \textbf{Legal frameworks and deal structures}

Real estate investments are mainly made via collective investment funds or standard special purpose vehicles (SPVs). Tax considerations usually determine the structure of foreign investment funds, depending on which double taxation treaty with Switzerland applies. Local investors usually acquire real estate directly in their own name, or in a business capacity via SPVs commonly known as real estate companies. The choice between acquiring property through a share deal or an asset deal largely depends on the type of property and the projects contemplated for the property.\textsuperscript{18}

\textsuperscript{15} https://www.six-group.com/exchanges/indices/data_centre/real_estate/sxi_realallshares_en.html.

\textsuperscript{16} Alexander Wyss/Mario Kumschick, Private Equity Real Estate und die KGK, in: Dieter Gericke, Private Equity III, pp. 211-279, 216.

\textsuperscript{17} https://www.finma.ch/en/finma-public/authorised-institutions-individuals-and-products/.

The main stages of a real estate transaction are similar irrespective of whether the structure of a share deal, an asset deal or a Transfer of Assets and Liabilities pursuant to the Swiss Merger Act (see below) is chosen by the parties. Typically, a real estate transaction consists of (1) a preliminary phase (includes preparation, tender phase, due diligence, negotiation phase), (2) signing, (3) closing, and (4) an integration phase.19

The preliminary phase usually starts with preparations, which include first meetings between seller and potential buyers. Sometimes, confidentiality agreements (NDAs) are signed at this stage. The result of the entering into contact will be the handing-in of non-binding indicative offers (NBOs) by the potential acquirers.20 Based on the NBOs, the seller will usually identify several parties, with which letters of intent may be concluded, and which will be given access to comprehensive information on the real properties (often by means of a virtual data room) to conduct a due diligence of the objects of sale. After the due diligence, the potential acquirers will hand in a binding offer.21 In case of a share deal, the due diligence will further cover the company, which is the object of sale and the owner of the real property to be acquired indirectly through the shares.

After due diligence and handing in of the binding offers, the seller will often select a small number of parties and enter into contractual negotiations with these. Eventually, if all stages are successful, there will be a signing of a contract, the closing and the subsequent integration of the transaction.22 Sometimes, depending on the volume of the transaction and its complexity, and especially if investments are made for the account of indirect investors (e.g., through collective investment funds), transactions are planned in detail and transaction manuals are established. Such manuals will also take into account regulatory requirements, which may significantly impact the timing of a transaction, such as permit requirements pursuant to Lex Koller23 or other restrictions.24

The process deviates from the above in case of a public tender offer, i.e. if an acquirer wishes to take over a public (listed) real estate company. In such a case – provided the takeover is friendly (supported by the board of directors of the target company) – the potential acquirer and the target real estate company usually enter into a transaction agreement and subsequently a public tender offer is launched.25 The public tender offer must include an offer prospectus, which has to contain all information necessary for the target company's shareholder to be in a position to take an informed decision about the offer.26 The information in the offer prospectus has to be in line with the minimum content specified by the regulations of the Swiss Takeover Board and must include: the involved persons (particularly the offeror and persons acting in concert with the offeror), the financing of the offer, conditions to the offer and an abstract of the future business plans of the offeror with the target company.27 The Takeover Board as well as the Swiss Financial Market Supervisory Authority (FINMA) supervise public tender offers.

20 ibid., p. 157.
22 ibid., p. 157.
23 Federal Law on Acquisition of Real Estate by Persons Abroad (SR 211.412.41).
24 ibid., p. 157.
26 ibid., p. 76.
27 ibid., p. 76.
ii Acquisition agreement terms

A basic legal principle of Swiss real estate law is that the creation of rights in rem requires the registration of such in the land registry. Every piece of land has its own file in the land register, which contains various information, particularly the identity of the current owner. Therefore, in asset deals, the transfer of title only occurs with the registration of the acquirer as new owner in the respective file of the land registry. Also, any rights of third parties pertaining to a plot of land must be registered in the land registry to be valid against a third party acquirer. Good faith in the information registered in the land registry is protected, which is why acquirers usually require legalised excerpts from the land registry of the plot(s) of land to be acquired dating from immediately before the acquisition to gain a full picture of the existing third-party rights or other encumbrances (such as easements, mortgages etc.).

The registration of a transfer of title in the land registry requires the filing of a public deed at the land registry. Such a public deed will have to be established before a notary public, who is only entitled to notarise public deeds in the canton, or depending on the cantonal law applicable, district, where he is competent to do so. Thus, an asset deal regarding several plots of land in different cantons requires the establishment of a public deed in every canton, where a plot is located.

A simplification to this exists for entities, which are registered in the commercial register. Such entities can transfer real property by way of a transfer of assets and liabilities pursuant to the Swiss Merger Act. In a Transfer of Assets and Liabilities, it is sufficient for the parties to establish only one transfer deed before a notary public at the domicile of the transferor, which will then be filed with the commercial register. Apart from bearing significant procedural simplifications, by relieving the parties to travel from canton to canton to have public deeds established and filed with the notary, a Transfer of Assets and Liabilities may also result in cost savings as notary fees can be significant in some cantons. Share deals are not subject to these form requirements.

A result of the requirement of a public deed is that the contract in case of an asset deal is still highly influenced by the drafting of the notaries. In other words, the contractual standard and its clauses have not converged with international standards as opposed to share deals, where Swiss law share purchase agreements regarding the acquisition of companies owning real estate have over the years become similar to contracts of similar deals in other countries.

As regards representations and warranties, Swiss law provides by default that the seller is liable to the acquirer that the object of sale has no physical or legal defects, which eliminate or substantially reduce its value or fitness for use. However, in asset as well as in share deals relating to real property with existing buildings, the parties often exclude the liability of the seller for physical defects and the real property is usually sold ‘as seen’.

An important warranty relates to the tenant list, which is usually included as a schedule to the contract (under Swiss law, the leases transfer to the acquirer and the acquirer has only limited possibilities to terminate the leases at transfer of ownership). The warranty usually

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29 ibid...
relates to the accuracy of the information in the tenant list. Further warranties typically found in contracts regarding the transfer of real property relate to the absence (1) of pending or threatening litigation with tenants, neighbours or authorities, (2) of environmental issues (pollution, hazardous substances, etc.) regarding the buildings or the soil, or (3) specific tax warranties.

In case of share deals, acquirers further typically ask for a representation regarding the correct organisation and valid existence, the correct presentation of the financial statements and the title to shares of the target company holding the real property.32

The purchase price in real estate transactions is usually fixed. Purchase price adjustment or earn out clauses are rare.33 A down payment of 10 per cent of the purchase price is common for assets deals, whereas there is typically no down payment in share deals.

Common conditions precedent to closing for real estate transactions are a Lex Koller ruling (see below) on the one hand and waivers of rights of first refusal on the other hand.34

iii Hostile transactions

So far no hostile transaction relating to listed real estate companies have occurred in Switzerland.

iv Financing considerations

In the context of asset deals, real estate transactions are mainly secured by the assignment of mortgage certificates for security purposes and the assignment of rental income claims for security purposes. Security interests by way of transfer of ownership on mortgage certificates for security purposes are extremely frequent in practice. Fund management companies and SICAVs may also use this financing structure. However, regulatory requirements provide that the financing may not exceed on average one third of the market value of all real estate assets. Mortgage financings are further limited by the so called Lex Koller (see Section IV.vi. below) if granted by foreign investors or banks. Foreign mortgage financings are usually limited to 80 per cent of the value of the underlying residential real estate assets; however, the financing of commercial real estate assets is not limited as, since 2002, this type of real estate is no longer encompassed by the Lex Koller restrictions.35 Assignment of rental claims, insurance claims and bank account claims usually completes the assignment of mortgages for security purposes.36

In the context of share deals, financing does not significantly differ from other business transactions. Financing thus occurs by means of equity or debt. Furthermore, the buyer sometimes aims to (partly) finance the purchase price from the target's assets.37

34 ibid., p. 17.
37 Wolfgang Müller, Andrea Sieber, Denise Läubli, GTDT, Real Estate M&A 2019 - Switzerland.
Tax considerations

The sale of directly held real estate property located in Switzerland (asset deal) generally triggers similar Swiss income tax consequences for both real estate funds and real estate companies. Applicable tax rates may however vary depending on whether a real estate fund or a real estate company is selling the property.

It should in this respect be noted that real estate funds are treated as non-transparent for Swiss income tax purposes with respect to any profits from direct real estate investments in Switzerland (such profit for example includes rental income as well as capital gains). In respect of these profits, the real estate fund as such is subject to Swiss income taxation. At the same time, these profits are generally exempt from Swiss income taxation at the level of the fund investors. Different from that, other income of the real estate fund is generally not taxed at the level of the real estate fund but directly allocated to the investors from a Swiss income tax point of view (tax-transparency).

Real estate companies are generally treated as opaque for Swiss income tax purposes. Hence, same as for real estate funds, the real estate company is generally subject to Swiss income taxation with respect to profits arising from an asset deal. Such profits may also be subject to income taxation upon distribution at the level of the shareholders.

As mentioned, the asset deal is therefore in principle taxed at the level of the real estate fund or the real estate company for Swiss income tax purposes but typically not at the level of the fund investors/shareholders. Capital gains are insofar generally subject to corporate income tax at federal level. At cantonal level, capital gains from an asset deal are taxed differently depending on the location of the Swiss property. In dualistic cantons (e.g., Geneva), capital gains from asset deals are generally subject to corporate income taxes only. In monistic cantons (e.g., Zurich), however, the part of capital gains corresponding to recaptured depreciations is subject to corporate income tax (i.e., the difference between the investment costs and the book value), whereas the remaining part of the capital gains is subject to a special real estate capital gains tax (i.e., the difference between the sale price and the investment costs).

An asset deal is usually subject to real estate transfer taxes, notary fees and land register fees. Furthermore, an asset deal is generally considered as a VAT-exempt turnover with no right to input VAT deduction. However, under certain conditions, the seller may elect to levy VAT on the sale price or to apply a notification procedure. An election for VAT may allow the owner of the plot to recoup input VAT paid on construction costs (so-called input tax deduction).

Distributions by Swiss real estate funds to their investors are generally subject to Swiss withholding tax of 35 per cent. However, distributions of profits resulting from asset deals (i.e., resulting from direct real estate investments in Switzerland) are exempt from such Swiss withholding tax upon distribution by a Swiss real estate fund. Distributions by Swiss real estate companies are generally subject to Swiss withholding tax of 35 per cent as well whereby no exemption similar to Swiss real estate funds exists with respect to distributions of profits resulting from asset deals. Investors may (partially) reclaim Swiss withholding taxes based on Swiss tax law or applicable double tax treaties.

In case of the sale of shares of a real estate company respectively the units of a real estate fund with direct real estate property investments in Switzerland (share deal respectively fund unit deal), generally no Swiss income tax consequences arise at the level of the real estate company or the real estate fund. Generally, Swiss private investors/shareholders achieve an income tax-free capital gain in a share as well as a fund unit deal. A share deal as well
as a fund unit deal generally triggers Swiss income tax consequences for Swiss corporate investors/shareholders whereby participation relief may apply allowing to (significantly) reduce the Swiss income tax burden. Foreign investors do generally not become subject to Swiss income tax solely as a result of disposing of shares or fund units in a share deal or a fund unit deal (however see below comment with respect to potential real estate capital gains tax consequences).

In certain cantons (typically in monistic cantons), a share deal may trigger the special real estate capital gains tax at the level of the shareholders as well as the real estate transfer tax usually at the level of the buyer (so-called economic transfer of property). However, typically (but not necessarily), 50 per cent or more of the shares of the real estate company need to be disposed of in order to fall into the scope of such economic transfer of property. Similar tax consequences may potentially apply at the level of fund investors in case of a fund unit deal. To the extent the special real estate capital gains tax applies, such tax would generally be secured by a legal lien on the Swiss property same as an asset deal.

With respect to foreign private and corporate investors/shareholders of real estate companies and real estate funds, the specific cantonal tax laws and particularly the applicable double taxation agreements determine whether Switzerland is indeed entitled to levy any real estate capital gains tax (or potentially income tax) in case of a share or a fund unit deal.

A share deal as well as a fund unit deal may be subject to Swiss transfer stamp taxes if a Swiss or Liechtenstein securities dealer for purposes of Swiss securities transfer stamp tax is involved as party or an intermediary to the transaction and no exemption applies.

vi Cross-border complications and solutions

According to the Kex Koller, the acquisition of real property in Switzerland by a so called person abroad (inter alia EU/EFTA citizens who are not resident in Switzerland, non-EU/EFTA citizens not holding a C permit or any legal entity that is domiciled abroad or controlled by persons abroad) is restricted as a matter of principle. While commercial properties (e.g., offices, restaurants, retail, etc.) can be acquired with no (or few) restrictions, residential properties can only be acquired if an authorisation is issued. In practice, authorisations to acquire residential properties are granted on very limited grounds. Restrictions affecting real estate assets used for commercial purposes concern commercial premises that are empty, that contain residential parts or areas, or that are acquired in anticipation of a company’s expansion in the short or medium term (but with no concrete plans to build at the time of the acquisition).38

An acquisition within the meaning of the Lex Koller can be both an acquisition of a plot of land (asset deal) and the acquisition of an interest in a real estate company (share deal), provided that the shares in the relevant legal entity are not listed on a Swiss stock exchange. Shares in a real estate company listed on a Swiss stock exchange can thus be purchased without an authorisation. In practice, (non-listed) holding companies often face a situation in which a company owns, as part of its assets, one or two residential buildings. Some cantons allow a company whose purpose is an operational one (e.g., to run an industrial plant or a hotel) to own, among its assets, up to 30 per cent of non-commercial (residential) real estate assets. The reference value for calculating this 30 per cent threshold is the market value of the real estate asset. Applied to holding companies, the 30 per cent threshold is calculated on a consolidated

basis, that is, on all real estate assets owned by the holding company’s subsidiaries. Since cantons are entrusted with the responsibility and power to apply and ensure compliance with the Lex Koller, the local practice must be checked prior to every transaction.

V CORPORATE REAL ESTATE

While there are numerous transactions in Switzerland resulting in a separation of corporate real estate from operating companies (opco / propco), there is no indication that this could become a general trend in Switzerland.

VI OUTLOOK

With Swiss interest rates resisting the upward trend in the US and EU, real estate continues to be an attractive investment proposition – at least in the short term.\(^{39}\) Due to the persistently high price level, it can be assumed that investments in the company’s own portfolio (development) will become more important than acquisitions. The number of transactions is thus expected to slightly decline.

Demographic change, digitisation and the development of interest rates are regarded as clear megatrends in the Swiss real estate sector going forward. Digitisation is expected to lead to increasing savings in various areas of activity (ancillary costs, accounting, letting and brokering, etc.). Furthermore, investors assume that co-working spaces will become a more important investment focus for office properties in the future due to digitisation. For residential properties, digitisation is expected to act as a driver for investments in serviced apartments, micro-apartments and central trend locations.\(^{40}\)

In early 2019 the first blockchain-based transaction in Switzerland was carried out. Specifically, a residential and commercial property in Baar (canton of Zug) was tokenised using Blockimmo’s transaction platform. Around three million Swiss francs or 20 per cent of the property value were tokenised and subsequently sold to four investors in a club deal. Whether real estate transactions based on blockchain technology could become a trend in the future is unclear at present.

\(^{39}\) KPMG, Clarity on Mergers & Acquisitions.
\(^{40}\) EY, Trendbarometer Immobilien-Investmentmarkt Schweiz 2019.
I OVERVIEW OF THE MARKET

Real estate investment trusts (REITs) were first introduced to the Turkish market in 1995. However, in the absence of relevant legislation, they did not receive much attention until the early 2000s. Following the economic crisis in 2002, REITs began to attract interest from both domestic and foreign investors.

As of today, there are currently 33 REITs established in Turkey, and shares for 31 of these are open to the public. Foreign investors have also invested in these REITs’ shares.

However, despite the foregoing, Turkey still is a traditional real estate market, and investors prefer direct investment in the property itself instead of capital market instruments. Accordingly, investments through REITs do not yet constitute a significant portion of Turkish real estate investments.

The government is taking measures to encourage and attract foreign investment especially in the real property sector. Pursuant to very recent legislation, any foreign person who purchases a real property with a value of at least US$1 million and undertakes not to sell the property within three years (this undertaking is registered in the land registry) is granted Turkish citizenship.

II RECENT MARKET ACTIVITY

i M&A transactions

Most of the transactions in the real estate sector are kept confidential and the deal values and structure are generally not publicly available.

According to publicly available information, a total of six transactions were concluded in 2016, with a total value of US$336 million.

The most significant of these transactions were the purchase of 5.25 per cent of the shares in Rönesans Holding by IFC for a total fee of US$215 million, and the purchase of all the shares in Alem Gayrimenkul by Ömer Hüseyin Alfadran for a total fee of US$70 million.

The number of real estate transactions slightly decreased in 2017; however, the total value was nearly doubled. In 2017, a total of five transactions were concluded, with a total value of US$650 million.

In 2017, the highest volume transactions in the real estate sector were the acquisition of İçerenköy Shopping Mall for US$320 million and the acquisition of Metropol İstanbul Shopping Mall for US$301.6 million by the Kefeli-Dekorsel Joint Venture. The acquisition...
of a 50 per cent stake in Adana Optimum Shopping Mall by Rönesans Gayrimenkul and the acquisition of İnegöl Shopping Mall by FIBA Commercial Properties were other noteworthy transactions in the sector although the deal values were not disclosed.²

In 2018, there were five real estate transactions with a total value of US$274 million. The most significant transaction was the purchase of Carrefoursa Maltepe by Bakırköy Gayrimenkul for a total fee of US$193 million.³

**ii Private equity transactions**

While private equity firms continue to invest in the real estate sector, it is not their main point of interest, as they prefer to focus on the information technology and energy sectors.

As mentioned above, most of the deals are kept confidential and the deal values and structures are not publicly available.

### III REAL ESTATE COMPANIES AND FIRMS

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

Shares of most of the REITs (31 out of 33) are publicly traded in Turkey.

Real estate investor companies, including but not limited to REITs, mainly focus on commercial properties such as shopping malls, high-street shops, hotels, tourist facilities, warehouses and industrial properties, as well as residential properties.

Commercial and industrial real estate investments seek either an exit within a couple of years or an ongoing rental income.

**ii Real estate PE firms – footprint and structure**

Similarly to REITs and REOCs, PE firms mainly focus on commercial properties such as shopping malls, high-street shops, hotels, tourist facilities, warehouses and industrial properties, as well as residential properties.

Commercial and industrial real estate investments seek either an exit within a couple of years or an ongoing rental income.

### IV TRANSACTIONS

**i Legal frameworks and deal structures**

The main piece of legislation regulating REITs is the Communiqué on Real Estate Investment Trusts (III-48.1) published in the Official Gazette No. 28660 dated 28 May 2013 (the Communiqué).

The Communiqué provides two main definitions with respect to REITs; namely infrastructure companies (InCos) and REITs. InCos are defined as a kind of REIT; however, there are certain additional requirements with respect to InCos, as explained in detail below.

The Communiqué defines InCos as capital companies or foreign companies, companies that will carry out infrastructure investment services in accordance with other public–private

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² Ernst & Young, ‘Mergers and Acquisitions Report Turkey 2017’.
³ Ernst & Young, ‘Mergers and Acquisitions Report Turkey 2018’.

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partnerships or privatisation models as determined under the legislation, or companies
established to carry out infrastructure investments and services that are carried out by public
authorities, social security institutions, local administrations and state-owned enterprises.
Infrastructure investments and services are also defined as agriculture, quenching,
mining, manufacturing, energy, transportation, communication, information technologies,
tourism, residential, cultural, urban and rural infrastructure, municipality services, urban
regeneration, environmental, research and development, education, health, justice, security,
genral administrative infrastructure and similar investments and services and projects
regarding these investments and services.
REITs are defined as capital market institutions established to operate a portfolio
consisting of real properties, real property projects, real property rights, infrastructure
investments and services, capital market instruments, bank deposits and other assets and
rights to be determined by the Capital Markets Board.
InCos should be established in such a way as to carry out only infrastructure
investments and services; and they cannot invest in real properties, real property projects
and real property-related rights. Similarly, REITs other than InCos also cannot invest in
infrastructure investments and services other than those carried out in relation to their real
property or real property projects and are of an incidental nature.
REITs may also be incorporated to invest in specific projects, real property or
infrastructure investments and services, or to carry out activities in a specific field. In such
cases, 75 per cent of the assets of the REIT should consist of investments in that specific field,
and the company name should include a reference to that activity, project, real property or
infrastructure investment and service.
InCos’ articles of association should also explicitly state that a minimum of 75 per cent
of the assets of the InCo should consist of infrastructure investments and services.
The minimum capital requirement for a REIT is 30 million Turkish lira. The minimum
capital requirement for an InCo is 100 million Turkish lira, without prejudice to exceptions
where at least one of the shareholders is a public entity and that shareholder holds at least
20 per cent of the share capital.
The natural persons and legal entities of the REITs’ incorporating shareholders:
a should not be bankrupt or have been declared bankrupt or have had a bankruptcy
proceeding postponed;
b should not have caused the operating licence of a company to be annulled by the
Capital Markets Board;
c should not have been convicted of any crime listed in the Capital Markets Law;
d should not have been sentenced to jail for a period of more than five years for a deliberate
crime or have been convicted of crimes against the security of the state, crimes against
the constitutional system, crimes of misappropriation, bribery and extortion, burglary,
 fraud, etc.;
e should provide the required resources for the establishment of the REIT from their
own commercial, industrial and other legal activities, free from any collusion, and
should have the financial capability to meet the undertaken capital amount;
f should have the required honesty and reputation;
g should not have any outstanding tax debt; and
h should not have been convicted of any crime listed in the Law on the Prevention of the
Financing of Terrorism.
Only real properties that are not subject to any mortgage or any other encumbrances that may directly and significantly affect the value of the property may be accepted as capital in kind. Any increase in capital in kind is subject to a general assembly decision, and shares issued in relation to such capital in kind may also be traded.

REITs must apply to the Capital Markets Board for approval for a public offering of their shares corresponding to at least 25 per cent of the REIT’s issued capital, and must maintain this situation following the public offering. Failure to comply with this requirement may result in cancellation of the company’s entitlement to act as a REIT.

If an investment has been made in a specific infrastructure company or project before the operation period or the ratio of the investments in infrastructure companies or projects in the operation period is less than 60 per cent of the total assets of the InCo, shares of the InCo may only be sold to ‘qualified investors’, who are deemed to be professional customers (i.e., customers who may take their own investment decisions and have the capability and experience to assess the risks related to their investments).

In principle, no privileged shares may be issued by REITs except for privileged shares that confer a right to nominate a candidate for the board of directors. However, following the public offer, no privileges including but not limited to nominating a candidate for the board of directors may be created. If the shares of the InCo are offered to qualified investors, this restriction shall not apply on the condition that it is provided under the articles of association and an exit right is provided in accordance with the legislation.

The shares of a REIT may either be issued as bearer shares or registered shares. Any transfer of privileged shares that may result in control of the management is subject to the approval of the Capital Markets Board.

The members of the board of directors should have, in addition to the requirements for the incorporating shareholders mentioned above, at least three years of experience in sectors such as real estate, infrastructure, law, construction, banking and finance. Experience only in the sale and purchase of real estate shall not be deemed sufficient experience. Furthermore, the majority of the members of the board of directors should be graduates of four-year university courses.

Any decision by the board of directors regarding the following should be announced and made public:

\[ a \] transactions between the REIT and:
- shareholders having at least 20 per cent of the shares or voting rights in the same ratio;
- shareholders having a privileged share to nominate a candidate for the board of directors;
- companies in which the parties mentioned in the first two points above have at least 20 per cent of the shares or voting rights in the same ratio;
- affiliates of the REIT;
- companies that provide management services to the REIT;
- companies that provide portfolio services to the REIT;
- companies that provide consultancy services to the REIT;
- contractors that provide construction services to the REIT;
- other shareholders of an ordinary partnership in which the REIT is a shareholder; and
- other persons affiliated to the REIT;

\[ b \] sale, purchase, lease or rental of an asset by the REIT;
The projects that will be carried out by REITs or in which REITs will make an investment should have all necessary licences and other legal documentation required for the commencement of the construction, and all the projects should have been approved.

REITs may invest in real properties in foreign countries provided that the ownership is registered on the REITs’ behalf. However, InCos may not invest in infrastructure projects abroad.

REITs are not allowed in any way to engage in project construction works, to employ personnel or procure equipment for such activities. REITs are also not allowed to commercially operate hotels, hospitals, shopping centres, business centres, commercial parks, commercial warehouses, residential sites, supermarkets, etc.

Furthermore, REITs are not allowed to provide project development, project control, financial feasibility or follow-up legal procedure services to third parties.

REITs may not give credits or debits that do not arise from the sale or purchase of goods.

Finally, REITs are not allowed to engage on a continuing basis in the short-term sale and purchase of real properties.

The ratio of the land acquired within the past five years on which no project has yet been developed shall not exceed 20 per cent of the total assets.

All construction and construction-related works such as drilling, renovation and restitution should be carried out for REITs by contractors in accordance with the agreement to be executed by and between the REIT and the contractor.

REITs are required to carry out an independent valuations through valuation companies in relation to obtaining new portfolios, sale and lease of assets in the portfolio, rental of real property to be leased out to third parties, etc.

ii Acquisition agreement terms

Most real estate transactions are concluded as share transfers rather than as asset transfers. This is mainly because of tax implications and land registry fees.

A total of 4 per cent of the sale price (2 per cent for both the seller and the purchaser) is required to be paid to the land registry as a land registry fee. This amount has been reduced to 3 per cent until the end of 31 December 2019 to encourage people to declare the actual sale price and to increase land registry fee income; however, whether this has been successful is questionable.

Apart from the land registry fee, income tax for natural persons and corporate tax for legal entities shall apply in the event that the property is sold within five years in the case of natural persons, and within two years for legal entities. Legal entities engaged in the sale and purchase of real estate are exempted from this exception.
Accordingly, most of the investors tend to engage in share transfers rather than asset transfers. The companies generally establish new companies to purchase properties, or demerge their companies by grouping one or more of the properties they intend to sell.

A share purchase agreement is executed to conclude a share transfer. Typical representations and warranties are included in the share purchase agreement. In addition to typical representations and warranties, representations and warranties regarding full and undisputed ownership, compliance with zoning plans, having all required licences for the construction and utilisation of the property (and the actual status of the property being in compliance with the licences even if the property has all the required licences) should also be included in the agreement, and non-compliance with these representations and warranties should be sanctioned with penalty clauses providing a sufficient figure to compensate all possible losses and pay any damages arising.

iii Hostile transactions
According to publicly available information, no hostile transactions have occurred in Turkey.

iv Financing considerations
Real estate transactions in Turkey are generally financed with equity capital, although bank financing is a popular alternative. The banks also offer mortgages to natural persons as buyers; however, the terms and interest rates do not favour the investor when compared with similar mortgages provided in other European countries or the United States.

Other financing methods, including but not limited to Islamic financing, are also gaining popularity.

v Tax considerations
In the case of a property transfer, both the buyer and the seller are required to pay 2 per cent (1.5 per cent until 31 December 2019) of the transaction value as a land registry fee. Furthermore, a fee of approximately US$200 for each transaction should also be paid into the revolving fund for land registry services.

If a promise-to-sell agreement is executed before the transfer of the ownership of the property, the agreement is subject to a stamp tax of 0.948 per cent on the highest amount in the agreement. The promise-to-sell agreement must be registered in the land registry to be effective against third parties, and the registration is also subject to a land registry fee of 0.683 per cent of the purchase value. However, this amount cannot exceed twice the amount of the real property tax value of the property.

In the case of a share purchase agreement, a stamp tax of 0.948 per cent should be paid on the highest amount in the agreement.

If a real property is sold by a natural person within five years of the acquisition date, the sale will be subject to income tax, calculated on the difference between the purchase and sale amounts.

Similarly, if a real property is sold by a legal entity within two years of the acquisition date, the sale will be subject to corporate tax, calculated on the difference between the purchase and sale amounts.

REITs have certain tax advantages as well in that they are exempted from corporate tax liability. Furthermore, the withholding tax ratio applicable to the revenues of a REIT, whether distributed or not, is determined as zero per cent.
vi Cross-border complications and solutions

Only foreign natural persons and Turkish capital companies with foreign shareholders are allowed to obtain the ownership of a real property or rights in rem pertaining to a real property.

Foreign capital companies established outside Turkey are not allowed to purchase real property or rights in rem pertaining to a real property in Turkey.

Foreign capital companies established in Turkey in which foreign shareholders have at least 50 per cent of the shares or have the right to appoint or dismiss the majority of the directors should make an application to and obtain the approval of the governorship where the target real property is located. The governorship obtains the opinion of the relevant institutions, such as the General Staff (the military) and the police force, to determine whether the target real property is located within a military or private security zone and whether the transaction may create a risk in terms of national security.

If the company falls within the scope of this requirement because of a share transfer, it should inform the Ministry of Economy. In such cases, an evaluation is made by the relevant authorities without there being any requirement to make an application. If the authorities deem that a risk to national security would be created, they inform the company and request that the real property be liquidated within, at most, six months. If the company fails to comply with this requirement, the real property is liquidated by the Ministry of Finance.

V CORPORATE REAL ESTATE

In Turkey, the operations of properties are generally carried out by operation or management companies. Accordingly, real estate companies either outsource the management or operation of the property to a third-party management company, or establish a dedicated management or operation company.

Because of reputation risk and to protect the value of newly constructed projects, property companies prefer to carry out the management of the project through a management company established by the property company itself.

The REITs are also required by legislation to use operation companies, as they may not be engaged in any way in the commercial operation of hotels, hospitals, shopping centres, business centres, commercial parks, commercial warehouses, residential sites or supermarkets.

VI OUTLOOK

Urban regeneration projects are on a short break due to economical conditions, however Turkey (especially Istanbul, Ankara and Izmir) continues to be a huge construction site. As the number of urban regeneration projects increases, there is a parallel increase in the number of problems and disputes arising from these projects.

Major infrastructure projects such as the Marmaray project (a tube line between Asia and Europe under the Bosphorus), the Yavuz Sultan Selim Bridge (or the Third Bosphorus Bridge), the Osman Gazi Bridge (a bridge between Istanbul and Yalova), the Eurasia Tunnel (a tunnel between Asia and Europe under the Bosphorus) and Sabuncubeli Tunnels (tunnels between the cities of Manisa and Izmir) and the new Istanbul Airport have been completed in the recent past, and other important projects such as the Istanbul–Izmir highway, Kanal Istanbul (a second channel between Black Sea and Marmara Sea in order to reduce transit vessel traffic in the Bosphorus) and the Çanakkale 1915 bridge are under way.
PPP projects are also very popular, especially in the health sector – city hospitals are being constructed in nearly every city in Turkey.

While not directly related to the real estate sector, energy projects, especially renewable energy projects, are also a very hot topic, and these projects involve real estate-related issues, and problems as well; these issues are likely to continue in the near future.
Chapter 24

UNITED KINGDOM

Richard Smith, Ed Milliner and Graham Rounce

I OVERVIEW OF THE MARKET

Whilst the issue of the United Kingdom’s exit from the European Union has continued to dominate the political landscape, the UK economy has, generally speaking, remained quite resilient. The government had, by the end of 2018, successfully completed its negotiations with the EU for a withdrawal agreement and a political declaration on the future relationship. However, Parliament has since repeatedly declined to give the approval required under UK domestic law, with the result that the UK was unable to leave, as originally intended, on the basis of a negotiated agreement on 29 March 2019. The European Council ultimately agreed to extend the UK’s membership of the EU to 31 October 2019 to allow time for the government to find a way to resolve the impasse. The Prime Minister, Theresa May, announced her resignation on 24 May 2019 and is expected to be replaced by July 2019 following a leadership contest. Whether her successor will have better luck in brokering a compromise and finding a way forward remains to be seen.

Although the continuing uncertainty has undoubtedly affected the real estate M&A and private equity markets, it is important to consider Brexit in a global context. The fear has always been whether the UK (and London in particular) will continue to attract inward investment and retain its appeal as a country in which to do business, and where people from around the world want to live and work.

Overseas investors will continue to look for attractive assets and income streams and, Brexit notwithstanding, UK real estate has retained its appeal as an investment safe haven. Indeed, there are a number of factors that have continued to make the UK an attractive, and slightly more affordable, global property hotspot. These include the ongoing weakness of the pound, historically low interest rates, low unemployment, better-than-expected economic data and continuing international economic and political instability. Although total investment volumes were down on 2017, activity remained above long-run averages and the UK is the leading European destination for cross-border investment. The United States and the Asia-Pacific region continue to dominate investment volumes. The effect of investment capital control measures on Chinese investment has been offset by interest from Hong Kong, Malaysia, Singapore, South Korea and the long-awaited return of Japan. Japanese funds have begun to look further afield for healthy rates of return and UK real estate is expected to be a major beneficiary.

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The office market has continued to evolve as it adapts to the requirements of occupiers. Technology, media and telecoms have been the dominant customers accounting for nearly a quarter of lettings. Flexibility and connectivity are the main requirements of the new generation of business occupier and this has been seized upon by the serviced office sector, which accounted for nearly 14 per cent of occupier activity in 2018. Operators in the co-working office sector are also competing with traditional investors for assets, for example WeWork’s acquisition of the 630,000 square feet Devonshire Square estate. The serviced office space boom has not been confined to London. Cities with a growing tech and media sector, such as Manchester, Glasgow, Birmingham, Milton Keynes, Cambridge and Oxford, have also benefitted. Channel 4’s new national headquarters in Leeds and new creative hubs in Glasgow and Bristol should prove catalysts for creative industries in those cities. Consolidation of a fragmented serviced office market seems likely to mean an increase in inter-operator M&A and a range of external players, including property funds and institutional investors, have started to acquire existing operators. In the wider market, significant deals have included Facebook’s new 611,000 square feet headquarters at Kings Cross Central, the Chinese Embassy’s acquisition of Royal Mint Court to create a new 600,000 square feet campus, the acquisition of the 400,000 square feet office building at 30 Gresham Street by Wing Tai Properties and Manhattan Garment Group and Blackstone’s sale of the 329,000 square feet office building at 125 Old Broad Street, EC2 to Singapore’s City Developments.

There has been no let up in a number of high-profile casualties in the retail and restaurant sectors. Major operators, including Debenhams, New Look, Poundworld, Homebase, Mothercare, HMV and Jamie’s Italian, have entered into insolvency processes. In particular, the use of company voluntary arrangements by insolvent companies to restructure their debts is facing increasing hostility from landlords, where many have been forced to accept reduced rents and closed outlets. It is estimated that almost 2,500 shops were lost from the UK’s high streets in 2018 as consumers continue to do their shopping, drinking and dining at home. Shopping centres and retail parks are having to reinvent themselves as leisure and experience destinations and retailers are busy adjusting their requirement for physical space to reflect the evolution of their online presence. On a more positive note, the prime central London market continues to attract luxury retailers eager to cash in on the spending power of affluent overseas visitors. The industrial sector has also benefited from the growth in online retail. Demand for large, well-connected and high specification sheds remains strong in the logistics sector and there has been a pick up in speculative development to meet the needs of occupiers. Key transactions included Blackstone and M7 Real Estate’s purchase of the Powerhouse portfolio and Legal & General’s acquisition of Woodside Industrial Estate.

The real estate investment market has continued to diversify as investors search for returns in alternative sectors. The UK hotel market accounted for 37 per cent of total investment in the UK specialist property sector and overseas buyers accounted for 78 per cent of volume. Total investment volume for 2018 was £7.4 billion, although the majority of this was transacted in the first half of the year. Private equity vehicles, including Starwood Capital, Apollo Global, Oaktree Capital Management and Lonestar, continued to divest their hotel stock. Key deals included Starwood Capital’s disposal of the 12-strong Principal Hotel Group to Covivio, Lone Star’s sale of the Amaris hotel portfolio and operating platform to LRC Group, Apollo Global Management’s disposal of its 20-hotel Holiday Inn and Crowne Plaza portfolio to HNW Dayan Family and Brookfield’s acquisition of the SACO Group. Key single asset deals included Grosvenor’s sale of the Beaumont Hotel, Cola Holdings acquisition
of the Hilton London Kensington and Katara Hospitality’s acquisition of Grosvenor House. Other attractive alternative asset classes include the private rented sector, logistics, student accommodation, data centres, retirement villages, energy and infrastructure.

The London residential property market remains subdued. House prices in central London remain the hardest hit with only a few of the outer boroughs offering limited growth as investors have looked further afield for value. The picture in the regions is more positive with Scotland and the north of England enjoying annual growth of around 7 per cent. The West Midlands and Birmingham have also seen healthy house price growth and this will be boosted by Birmingham hosting the 2022 Commonwealth Games and the City’s associated redevelopment projects. Plans to introduce an additional 1 per cent Stamp Duty Land Tax (SDLT) surcharge on non-residents acquiring residential property in England and Northern Ireland will increase the burden of an already punitive tax regime. On a more positive note, a lack of supply means that medium to long-term prospects remain good and price reductions in the ‘super-prime’ market have created buying opportunities.

In financing, the market has remained strong in the face of ongoing political and economic uncertainty. New lending for real estate rose by 12 per cent in 2018 to reach £49.6 billion and there was an increase in new loan origination against outstanding loan books. The appetite for risk has varied across the sectors with a marked increase in the cost of loans secured against retail property. Alternative lenders have continued to be active and non-bank lending has become an established part of the real estate finance sector.

II RECENT MARKET ACTIVITY

i Transactions

Blackstone Property Partners and Telereal Trillium have agreed to acquire a £1.46 billion commercial real estate portfolio from Network Rail Infrastructure involving 5,200 assets.

Real estate funds managed by The Blackstone Group acquired a European logistics portfolio from Industrial Securities Europe and MCAP Global Finance for £433.57 million.

Bowmark Capital, MML Capital Partners and management acquired The Instant Group, an independent flexible workspace provider.

The Reuben Brothers acquired Burlington Arcade from Thor Equities and Meyer Bergman for £300 million.

KKR and Round Hill Capital acquired a portfolio of four student accommodation developments from Watkin Jones Group for £180 million.

The Blackstone Group acquired M7 Real Estate’s Column portfolio for £110 million.

Sekisui House acquired a stake in Urban Splash.

Singapore Press Holdings has acquired a portfolio of purpose-built student accommodation units from Unite for £180 million.

Aprirose acquired a 45-asset Spirit Pub Company portfolio from British Land for £130 million.

Westbrook Partners has acquired a portfolio of light industrial estates and trade counters from IO2 for £140 million.

Employees Provident Fund and Permodalan Nasional Berhad acquired Battersea Power Station Building for £1.6 billion.

Sourced acquired the Regent Plaza residential development in Manchester for £150 million.
Ashby Capital acquired Kensington Arcade and 127 Kensington High Street from Columbia Threadneedle Investments for £200 million.

Tritax Big Box REIT has agreed to acquire an 87 per cent interest in db Symmetry from DV4, a fund managed by Delancey Estates, for £322 million.

Avison Young has agreed to acquire GVA Grimley from Apleona.

Hana Alternative Asset Management has agreed to acquire Sanctuary Buildings from The Blackstone Group for £280 million.

Arlington Advisors and Equitix acquired student accommodation in Leicester and the Stellar Portfolio for £280 million.

UK Commercial Property REIT acquired a portfolio of five distribution warehouses in the Midlands from Clipstone Logistics for £85.4 million.

Stenprop acquired a portfolio of 22 industrial properties from Hansteen Holdings for £67.9 million.

Hana Alternative Asset Management acquired One Poultry for £185 million from Aermont Capital.

Kiwoom Asset Management acquired Cannon Green from Ocubis for £120 million.

Korean institutional investors acquired 125 Shaftesbury Avenue from Almacantar for £270 million.

Ella Valley Capital acquired 55 Gresham Street from Angelo Gordon and Beltane Asset Management for £180 million.

An Asian investor has agreed to acquire a 50 per cent interest in Highcross shopping centre in Leicester from Hammerson for £240 million.

Singapore’s City Developments acquired 125 Old Broad Street from Blackstone for £390 million.

Ares Management has agreed to acquire a portfolio of 12 assets from AEW UK South East Office Fund for £140 million.

An Asian family office has agreed to acquire London Executive Offices from Queensgate Investments for £480 million.

Dobbies Garden Centres acquired 31 garden centres from Wyevale; this followed the earlier acquisition of six Wyevale centres.

Global Infrastructure Partners disposed of a 50.01 per cent shareholding in London Gatwick Airport.

Liberty Property Trust acquired a portfolio of warehouses and logistics centres from Leftfield Properties for £110 million.

Norges Bank Real Estate Management acquired 60 Holborn Viaduct for £320 million from Hines.

Deka Immobilien acquired Verde SW1 from Tishman Speyer and PSP Investments for £460 million.

Singapore’s City Developments acquired Aldgate House from Hermes Real Estate Investment and Canada Pension Plan Investment Board for £180 million.

Ascendas REIT acquired a portfolio of 12 logistics properties from Oxenwood Catalina for £257 million.

Spelthorne Borough Council acquired a £290 million portfolio from Brockton Capital and Landid Property Holdings.

Pontegadea Immobiliaria acquired the Adelphi Building for £550 million from the Blackstone Group.
JT Real Estate entered into a joint venture to acquire a prime residential scheme at 185 Park Street from Delancey Estates for £400 million.
Capreon acquired two retail parks from Hammerson for £160 million.
Korea Asset Investment Management acquired Gallagher Shopping Park in the West Midlands for £180 million from KKR and Quadrant.
FG Asset Management and The Valesco Group agreed to acquire 20 Old Bailey for £340 million from The Blackstone Group.
Lendlease and London & Continental Railways sold offices at International Quarter London to DWS Group for £240 million.
Korea Investment & Securities acquired 70 Mark Lane for £200 million from Mitsui Fudosan and Stanhope.
Aviva Investors sold 20 Soho Square for £120 million.
CK Asset Holdings acquired 5 Broadgate from GIC and British Land for £1 billion.
M&G Investment Management acquired Charterhouse Estate for £256 million from Anglo American.
M&G Real Estate acquired a 50 per cent stake in Fort Kinnaird for £170 million from the Crown Estate.
Strathclyde Pension Fund acquired a retail parade in Clapham for £130 million from Delancey.
Starwood Capital agreed to sell its Principal Hayley hotel platform to Foncière des Régions for £750 million.
Wing Tai Properties and Manhattan Garments Group acquired 30 Gresham Street for £400 million from Samsung Life.

**IPOs**
Glenveagh Properties raised €213 million with its firm placing and open offer to fund new developments.
Tritax EuroBox raised £300 million through its placing, offer for subscription and intermediaries offer on the Specialist Fund segment of the main market of the London Stock Exchange.
Yew Grove REIT issued 72.5 million shares on the Alternative Investments market of the London Stock Exchange and on Euronext Dublin.
Urban Exposure raised £165 million on its AIM listing.

### 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 the main corporation tax rate. While not all property companies are REITs by any means, the largest corporate real estate groups are structured as REITs to benefit from these tax advantages. As a result, M&A involving UK REITs will have specific considerations that will need to be taken into account.
**Main conditions**

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

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 admitted to trading on a recognised stock exchange, and either listed or actually traded on such an exchange;

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

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

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

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.

**ii Recent developments**

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

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

iii Real estate private equity firms

Structure

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

- has a finite life (usually 10 years with a possible two-year extension, although some have investors with rolling annual commitments);
- has one general partner with unlimited liability for the liabilities of the partnership;
- has a number of limited partners (LPs) whose liability is limited to the amount of their equity investment in the partnership; and
- 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 Partnerships Act 1907, must have unlimited liability for the liabilities of the private equity fund. However, the individual partners cap their liability by investing through a limited company. Individual partners of the private equity fund manager are required to invest their own money directly in the fund (usually between 1 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 have been major investors in UK real estate in recent years. Investment has been made across a wide range of sectors including hotels, residential schemes, housebuilding, health care, student housing, restaurants, serviced offices, logistics and retail.

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

IV TRANSACTIONS

i Legal frameworks and deal structures

Legal frameworks

When investors acquire or dispose of real estate in the United Kingdom, the majority of the 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 on, in each case, a number of factors and considerations (including funding, tax and exit routes (for private equity funds)). Typical structures include:

- a) companies limited by shares: body corporates with a legal personality distinct from those of their shareholders and directors; these companies are governed by the Companies Act 2006;
- b) limited partnerships: discussed above in relation to private equity firms;
- c) limited liability partnerships (LLPs): bodies corporate with a legal personality distinct from those of their members. Members have limited liability in that they do not need to meet the LLP’s liabilities. They are governed by the Limited Liability Partnerships Act 2000 and the Companies Act 2006;
- d) joint ventures: there are no laws relating specifically to joint ventures under English law. Their structure will be determined by the nature and size of the enterprise, the identity and location of the parties and their commercial and financial objectives. The relationship between the parties will be subject to, depending on the structure, general common law rules, the legislative provisions of company and partnership law and the provisions of the 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 a way to make contractual claims in respect of warranties and post-completion purchase price adjustments.
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 seller’s counsel.

The extent of the sales and purchase agreement (SPA) provisions will vary depending on the nature of the transaction, the real estate assets in question and the due diligence undertaken. However, there are a number of aspects to consider.

Conditionality

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

Splits between signing and completion

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

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

b) EU merger clearance is required;

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

d) rescission is possible between signing and completion;

e) any deposit paid at signing should be returned to, or forfeited by, the buyer if the transaction does not complete; and

f) management of the underlying properties is required and, if so, whether the buyer will exercise control.

Rescission

Where there is a split between signing and completion, this may affect whether 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 this period the buyer should face the potential risks and be unable to rescind.

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

Buyer protections

In UK real estate acquisitions, buyer protections are particularly important as the buyer is not afforded any statutory or common law protection on acquisition; caveat emptor (buyer beware) applies. Where 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 a normal due diligence exercise or reliance on certificates of title issued by the seller’s lawyers. Recently we have seen a move towards title insurance as a
way for the buyer to deal with title due diligence, sometimes in combination with purchaser due diligence or certificates of title, or both of these. A combination of approaches is not uncommon on portfolio deals with properties of various values or significance.

**Warranties**

Although sellers (particularly private equity sellers) will not want to provide a large number of warranties on the sale of real estate assets, they are important to provide 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.

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 liabilities) and that risk is not easily quantifiable, specific indemnities will be sought, shifting the exposure to the seller. Warranty claims are difficult to make in practice, so indemnities are preferable from the buyer's perspective. Sometimes title insurance to protect against a specific title defect can be obtained.

**Seller protections**

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

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

As 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.
ii Financing considerations

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

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

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

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

iii Tax considerations

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

If real estate assets are sold and purchased directly, the default position is that the sale or purchase in the United Kingdom is not subject to VAT, 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. Otherwise, even if the buyer can recover all of its VAT, the VAT amount will count towards the SDLT calculation and thus create an absolute cost in all cases.

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

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

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

V OUTLOOK

Although it is impossible to predict the future, the outlook for UK real estate M&A and private equity is more positive than had been feared. Brexit will undoubtedly have a significant effect on the market for some time to come, irrespective of when, how or indeed if the UK leaves the EU. Taking a global view, it can be argued that the UK’s position is such that membership of the EU has limited significance and that London will remain a truly global city irrespective of Brexit. Continuing global political and economic uncertainty, including the escalation of the US-China trade war, political instability in Europe, ongoing concerns about the Chinese economy and the threat of confrontation with North Korea, suggest that UK real estate will continue to attract global investment capital. Indeed, to many overseas investors, the tightening of the UK’s tax regime for the direct or indirect disposal of UK commercial property by non residents will be of a far greater significance than Brexit.

Other concerns for investors include the threat of a Labour government and the proposed introduction of a new beneficial owners register for overseas entities holding UK real estate.

UK real estate is, of course, only one aspect of a multi-faceted global investment market. Competition is strong and the UK must work hard to continue to attract inward investment. Areas of concern include the need for an investor-friendly tax regime, flexible planning laws, an acceptable immigration policy, a fully functioning hub airport and other infrastructure, affordable housing stock and the preservation of London’s status as an international centre of legal excellence. Progress on transport infrastructure remains slow. Completion of the
Elizabeth line has been further delayed and the expansion of Heathrow Airport has faced legal and political challenges. The government is also still to commit to much needed new transport projects, such as Crossrail 2 and the Northern Powerhouse rail network. The UK’s immigration policy post Brexit will be a major factor if the UK is to retain its status as a place to do business. The UK’s continued success is dependent on its ability to attract both a skilled and unskilled workforce. The opportunities offered by other leading global cities, the rest of Europe and the world’s emerging economies will provide stiff competition for the increasing amounts of global capital available for investment.

Although risks and challenges remain, UK real estate will retain its appeal for overseas investors and maintain its key role in the global investment market. There will be plenty of opportunities in the UK real estate M&A and private equity markets as a wide range of investors continue to look for value and higher rates of return across the full spectrum of real estate assets. Practitioners can help their clients to develop an appropriate strategy to ensure that risks are assessed and monitored and opportunities are taken.
I  OVERVIEW OF THE MARKET

The REIT sector in the United States has expanded dramatically over the past quarter century. 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 approximately US$2 trillion of commercial real estate, and the industry’s equity market capitalisation is over US$1.2 trillion. There are now approximately 137 REITs in the United States with a market capitalisation over US$1 billion, and 29 of those are over US$10 billion. Compare this to 1995, when the entire market capitalisation of the US REIT industry was just US$57.5 billion, and there were only six REITs with a market capitalisation over US$1 billion.

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, healthcare, timber, data storage, outdoor advertising and gaming.

Along with REITs, private equity (PE) funds have also become dominant institutional players in US commercial real estate over the past 20 years. At the sector’s fundraising peak in 2008, real estate PE funds raised over US$130 billion per annum. While fundraising following the 2008 financial crisis has not yet reached that level, PE funds have continued to raise large amounts of capital (reaching US$118 billion in 2018) 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 PE funds.

Technological change continues to drive significant activity for REITs and real estate PE funds. REITs that harness the technological momentum or provide the infrastructure for the new economy, including data centres, cell towers and logistics facilities, are growing

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2 NAREIT REITWatch (data as of 31 March 2019).
3 S&P CapitalIQ.
6 Preqin Quarterly Real Estate Update, Q4 2018 and Q1 2019.
rapidly. On the other hand, traditional retail REITs and REITs in other disrupted sectors are working hard to adjust to the new environment through restructurings, redevelopment and other changes. Already, four of the ten biggest REITs are so-called ‘tech-REITs’, and the trend shows no sign of slowing.

II RECENT MARKET ACTIVITY

i M&A transactions

Recent M&A activity has been focused primarily on PE funds’ acquisitions of public REITs (public-to-private transactions) and combinations of REITs (public-to-public deals), with REIT spin-offs and restructurings to unlock the value of corporate real estate also playing a role. The take-private transactions have been driven largely by PE firms’ belief that their target REITs are trading at a discount to the value of their assets, thus providing an opportunity to profit from the arbitrage. The public merger transactions, on the other hand, have been a function of the continuing consolidation in the various REIT sectors in order to create scale, benefit from synergies and carry out strategic growth plans, among other reasons.

ii PE transactions

PE 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 Brookfield Asset Management acquired Forest City Realty, which owned apartment buildings, shopping centres and other assets, in an all-cash transaction valued at approximately US$11.4 billion in December 2018. The price represented a 26.6 per cent premium for the target’s stock, and the agreement had a break fee of $261 million and a reverse break fee of $488 million. The acquisition followed years of pressure from activist investors at Forest City, ultimately leading to the elimination of the company’s dual class voting structure, which reduced the founding family’s control over the company and paved the way for an acquisition.

b Blackstone purchased Gramercy Property Trust, an owner and manager of industrial commercial real estate, in October 2018 in an all-cash transaction valued at US$7.6 billion. The price represented a 15 per cent premium for the target’s stock, and the agreement had a break fee of US$138 million (or US$46 million under certain circumstances) and a reverse break fee of US$414 million. Additionally, while not a ‘take-private’ of a public REIT, in June 2019 Blackstone agreed to purchase assets comprising approximately 179 million square feet of warehouse space from GLP, a Singapore-based developer of logistics properties, for US $18.7 billion in one of the largest ever private real estate transactions globally. The transaction will nearly double the size of Blackstone’s US industrial footprint and is emblematic of its long-term bet on logistics-related spaces, which it expects to benefit from growing e-commerce demand.

c Greystar Real Estate Partners acquired Education Realty Trust (EdR), one of the largest developers, owners and managers of collegiate housing communities in the US, for US$4.6 billion in cash in September 2018. The price represented a 13.6 per cent premium for the target’s stock, had a break fee of approximately US$118 million
and a reverse break fee of US$200 million. In connection with the acquisition, funds associated with Blackstone acquired EdR’s student housing portfolio for US$1.2 billion in cash.

d Brookfield Asset Management purchased GGP Inc., the then-second largest owner of mall space in the US, in which Brookfield was a dominant investor, in August 2018 for approximately US$15 billion in cash and stock, a premium of approximately 20 per cent to the price of GGP’s stock prior to widespread rumours of Brookfield’s interest. The agreement had a break fee of US$400 million and a reverse break fee of US$1.2 billion.

e Blackstone purchased Excel Trust, which owned shopping centres and other retail assets, for about US$2 billion in July 2015. The deal represented a 15 per cent premium for the target’s stock, had a US$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 US$250 million.

f Lone Star Funds acquired Home Properties, an apartment REIT, for US$4.4 billion in October 2015. The deal represented a 9 per cent premium for the target’s stock, had a US$150 million break fee and had a reverse break fee of US$300 million.

g Blackstone purchased Strategic Hotels and Resorts, an owner of luxury hotels, for approximately US$6 billion in December 2015. The deal represented a 13 per cent premium for the target’s stock, had a US$100 million break fee and had a reverse break fee of US$400 million.

h Blackstone also acquired BioMed Realty Trust, which focused on office space for pharmaceutical and biotechnology companies, for US$8 billion in January 2016. The deal represented a 24 per cent premium for the target’s stock, had a US$160 million break fee and had a reverse break fee of US$460 million.

iii Public 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 Cousins Properties’ acquisition of TIER REIT, Inc., a US$7.8 billion cash and stock transaction (announced March 2019);

b Government Properties’ US$1.2 billion all-stock merger with Select Income REIT, with the combined company renamed Office Properties Income Trust (December 2018);

c Pebblebrook Hotel Trust’s acquisition of LaSalle Hotel Properties for a mix of cash and stock that valued LaSalle at US$5.4 billion. The acquisition represented the conclusion of Pebblebrook’s nine-month pursuit of LaSalle, which terminated its original agreement with Blackstone in order to accept Pebblebrook’s topping bid (November 2018);

d Taylor Morrison Home Corporation’s acquisition of AV Homes, a cash and stock transaction valued at approximately US$963 million in enterprise value (October 2018);

e Annaly Capital Management’s acquisition of MTGE Investment Corp., a transaction valued at approximately US$900 million in equity value (September 2018);

f ProLogis’ acquisition of DCT Industrial Trust, a US$8.4 billion stock-for-stock transaction, including the assumption of debt (August 2018);
Welltower’s acquisition of Quality Care Properties and Quality Care Properties’ acquisition of HCR ManorCare at the completion of HCR ManorCare’s Chapter 11 bankruptcy process, a transaction valued at approximately US$3.9 billion (July 2018);

Penn National Gaming’s acquisition of Pinnacle Entertainment, a transaction valued at approximately US$2.8 billion in enterprise value (October 2018);

Kennedy-Wilson Holdings’ acquisition of Kennedy Wilson Europe Real Estate Plc, creating a leading global real estate investment and asset management platform with a US$8 billion enterprise value (October 2017);

Digital Realty Trust’s acquisition of DuPont Fabros Technology, a transaction valued at approximately US$7.8 billion in enterprise value (September 2017). DuPont Fabros shareholders received shares of Digital Realty in the merger;

Sabra Health Care’s acquisition of Care Capital Properties, creating a combined healthcare REIT with a pro forma total market capitalisation of approximately US$7.4 billion and an equity market capitalisation of approximately US$4.3 billion (August 2017). Care Capital Properties shareholders received shares of Sabra Health Care in the merger;

Regency Centers’ acquisition of Equity One, creating a combined shopping centre company with a total market capitalisation of approximately US$16 billion (March 2017). Equity One was merged into Regency, and its stockholders received shares of Regency in the merger;

Annaly Capital Management’s acquisition of Hatteras Financial Corp., a transaction valued at approximately US$1.5 billion in equity value (July 2016). Hatteras stockholders received shares of Annaly common stock and/or cash (at their election) in the merger;

Starwood Waypoint Residential Trust’s acquisition of Colony American Homes and internalisation of its manager, creating a combined company, renamed Colony Starwood Homes, with a combined asset value of approximately US$7.7 billion (January 2016). Starwood Waypoint Residential Trust and Colony American Homes shareholders received shares of Colony Starwood Homes in the merger;

Chambers Street Properties’ acquisition of Gramercy Property Trust, creating an industrial and office net lease company with an enterprise value of approximately US$5.7 billion (December 2015). Gramercy stockholders received shares of Chambers Street in the merger;

Washington Prime Group’s acquisition of Glimcher Realty Trust, a transaction valued at approximately US$4.3 billion (January 2015). Glimcher shareholders received shares of Washington Prime and cash in the merger;

Essex Property Trust’s acquisition of BRE Properties, creating a multi-family apartment company with a market capitalisation of US$15.4 billion (April 2014). BRE shareholders received Essex stock as well as cash in the merger; and

American Realty Capital Properties’ acquisition of Cole Real Estate Investments, creating the largest net lease REIT with an enterprise value of US$21 billion (February 2014). Cole stockholders received American Realty Capital Properties stock or cash in the merger.

iv 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:

- 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.  

- 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 US$2.7 billion in value for the assets funded through the rights offering and financing on the assets.  

- 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.

**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 Simon Property Group’s spin-off of its shopping centre business and smaller malls into Washington Prime Group (May 2014); Vornado’s spin-off of its shopping centre business into Urban Edge (January 2015); Ventas’ spin-off of its skilled nursing portfolio into Care Capital Properties (August 2015); Vornado’s spin-off of its Washington, DC assets into JBG Smith Properties (July 2017); and DDR’s spin-off of its lower-quality US strip centres and its Puerto Rico portfolio (announced December 2017).

### III REAL ESTATE COMPANIES AND FIRMS

**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).

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7 Note that tax-free spin-offs of this nature are no longer permissible – see Section V for further information.
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. 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’, 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 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, as discussed further in Section IV.v.

### ii Real estate PE firms – footprint and structure

Real estate PE 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. PE 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 PE business, describes the strategy of its opportunistic funds simply as ‘buy it, fix it, sell it’ – 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. PE 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, PE 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, PE funds may work to take REITs private.

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8 For further discussion of the anti-takeover implications of excess share provisions, see Section IV.iii.
9 Short for ‘umbrella partnership real estate investment trusts’.
11 This investment-style overview is based on the categories used by the National Council of Real Estate Fiduciaries.
Real estate PE 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. PE 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.¹²

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’. While 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, forward triangular mergers have been the predominant REIT M&A transaction structure due in large part to tax considerations. The decision to choose a forward or reverse triangular merger structure often depends 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 or 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 unitholders over REIT-level transactions and the redemption and conversion mechanics that will apply to unitholders 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.13

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, 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 an affiliated stockholder or unitholder seeks out a PE buyer to submit a joint bid to acquire a 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 unitholders, the board should consider any possible differing interests as between unitholders and shareholders. When a special committee is formed, it should be firmly in control of the transaction 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 sale 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 exist. Often, a simple recusal or deploying a different procedural safeguard is a more appropriate way to address the aforementioned employment negotiations. Such a targeted approach allows the full board to draw on its members’ collective expertise to handle matters for which there are no conflicts.

13 Md Code Ann Corps & Ass’ns, Section 2-405.1(f).
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. Generally, REIT mergers have ‘fixed basket’ consideration, whether cash, stock or a combination of the two, with the amount and form of such consideration determined at signing, while only a minority of transactions provide for post-signing variation in amount and form of the ‘basket.’

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 incurable breach of the merger agreement, failure to obtain shareholder approval or 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 an expense reimbursement fee to the acquirer. The size of the break-up fee is typically heavily negotiated and will often depend in part on the extent of the pre-signing market check conducted by the target’s board. Where a target has conducted a robust pre-signing market check, such as an auction process, the target will typically be subject to ‘no-shop’ obligations coupled with a higher break-up fee. On the other hand, a target that has not engaged in an extensive pre-signing market check may try to negotiate a ‘go-shop’ provision, allowing it to solicit a better deal for its shareholders for a fixed period following signing, paired with a lower break-up fee. One compromise approach to balancing deal protections while preserving a board’s ability to fulfil its fiduciary duties is to allow for a post-signing market check by coupling a ‘no-shop’ provision with a two-tiered break fee that is low for an initial fixed period (e.g., 1.0-1.5 per cent of the equity value of the transaction for a 30-45 day period after signing) and ratchets up thereafter (e.g., 2.5-3.25 per cent). While the bifurcated break-up fee structure still remains a minority approach in REIT M&A deals, a number of recent transactions, including Blackstone’s 2018 acquisition of Gramercy Property Trust, have included such a construct. Reverse break-up fees (payable by the buyer in the event of certain termination events) are common in PE deals, and operate much like a traditional real estate deposit. Recent reverse break-up 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 the approval of unitholders, 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.
Additionally, the delivery of an opinion that the target qualifies as a REIT is uniformly required, with the buyer's tax counsel also providing such assurances in a stock-for-stock transaction.

**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, and the aforementioned events at Forest City Realty. Activists may also pressure REIT boards to consider a sale of a company, particularly if there is a large spread between the market value of the REIT and the net value of its assets. Alternatively, activists may agitate for sales of certain assets to capture arguably unrecognised value, adjustments to leverage, dismantling of takeover defences or for the replacement of management or directors.

While activist campaigns against REITs have historically often stayed under the radar, they are becoming more mainstream, particularly as well-capitalised, higher-profile and non-REIT-dedicated activists increasingly look to the REIT sector. In 2018, 14 new activist campaigns were launched against REITs, ranging from shareholder proposals to declassify boards or otherwise dismantle representing a significant increase in activity. In 2018, 4.46 per cent of all announced activist campaigns against US companies were in the real estate sector.

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14 SharkRepellent.
15 S&P CapitalIQ (includes all announced activist campaigns against US companies with market capitalisations above US$50 million).
More broadly, US REITs incorporated in Maryland have recently faced pressure from investors and proxy advisory firms to opt out of the Maryland Unsolicited Takeovers Act, which allows boards to take certain actions, including classifying themselves without shareholder approval, and to remove prohibitions or restrictions on shareholders’ ability to amend by-laws.

**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 the 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, the 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 unitholders (especially since the interests of unitholders and shareholders can be different). The UPREIT structure allows REITs to provide property owners with 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 unitholders often have tax protection agreements in place (designed to perpetuate a contributing operating partnership unitholder’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 unitholder). This may influence the 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.

Where an UPREIT is being purchased by a private equity buyer, there is no surviving publicly held entity, so the flexibility and protections previously available through the conversion of operating partnership units into stock or its cash equivalent often must be replaced with a security that satisfies the unitholders’ needs. For example, unitholders may
be offered an option to elect to receive a fixed-return preferred security or a combination of consideration including a mixture of cash and preferred securities. Issues to consider when creating the security include the yield, windows for puts and calls and redemption rights, voting rights (if any), and continuing tax protection arrangements.

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 gains 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.

Acquisitions 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 reviews will affect typical real estate transactions. However, the Foreign Investment Risk Review Modernisation Act of 2018 (FIRRMA), represents a large expansion of CFIUS’s jurisdictional reach, and may portend greater regulatory scrutiny of foreign investment in general. 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 a 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

REITs today are confronting a rapidly changing environment, with nearly all sectors facing some degree of external disruption. Technological change continues to transform real estate business models, a trend that is likely to accelerate further and become more pervasive over the next five to ten years, creating risks and opportunities for REITs that will be forced to either adapt or in some cases become obsolete. Indeed, with the coming roll-out of 5G technology and the continued growth of artificial intelligence-related products and services, the growth and consolidation of technology-focused REITs will likely pick up pace, with these and other ground-breaking technologies continuing to impact REITs and their business models in unpredictable ways.

In 2018, REIT equities suffered the same fate as the broader market, as the MSCI US REIT Index fell by approximately 4.57 per cent for the year,16 roughly in line with the broader performance by the S&P 500.17 Still, the value of assets held by REITs continues to grow,18 underscoring the strength of the sector and the advantages that the REIT structure brings to the investment community. Additionally, REIT equities have come roaring back during the first five months of 2019, with the MSCI US REIT Index up more than 20 per cent since its December 2018 nadir, further narrowing the NAV gap at many REITs.19

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. However, with the NAV gap at many REITs narrowing or even flipping to a premium, ‘take privates’ may fade in prominence, with only a small number of private equity firms continuing to dominate the space. This dynamic will continue to make ‘club’ bids difficult, and will require sellers to be careful and creative when designing a sale process. The resulting complex bidding processes, coupled with a dearth of big bidders, will result in more transactions that allow for a meaningful post-signing market check. 2019 and beyond will see REIT founders without a viable succession plan consider selling into these favourable market conditions. The coming months may also bring more public-to-public deals amid greater CEO and board confidence, with trade disputes and their impact on global growth a wild card that could flip such predictions on their head.

An increasingly vocal group of activists targeting REITs is likely to continue to push for M&A activity, particularly as they perceive that some REITs continue to trade at significant discounts to their net asset value. While many of the REIT activists are thinly capitalised and

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18 See Section I for further information.
19 Bloomberg, as of 13 June 2019.
United States

often have a short-term outlook, they have sometimes been successful garnering the support of institutional investors, further empowering their initiatives. The trend of unlocking corporate real estate value through transactions using the REIT structure will likely continue, although such activity has, and is expected to continue to, slow because of the recent restrictions on the use of tax-free REIT spin-offs.

In the short term, trade uncertainty, trans-oceanic regulatory barriers, or a downturn in the broader commercial real estate market may complicate the outlook for real estate M&A, with the return of Chinese capital to the real estate market unlikely given the current regulatory environment. However, in the long term, the liquidity and transparency of, and access to capital in, the public US real estate market makes the growth of REITs seem inevitable.
Chapter 26

VENEZUELA

Fulvio Italiani, Carlos Omaña, Arnoldo Troconis and Inés Parra

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 controls 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 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 and foreign investors with high risk appetite. The main transactions taking place in Venezuela are related to the purchase, sale, construction, financing, development and acquisition of office buildings, sports training centres, retail stores, hotels and shopping centres projects.

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 that in other jurisdictions:

a the signing of confidentiality agreements or non-binding letters of intent;

b due diligence investigations;

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1 Fulvio Italiani, Carlos Omaña, Arnoldo Troconis and Inés Parra are partners at D’Empaire.
c negotiation of stock or asset purchase agreement;
d signing of the agreement;
e disclosure of the transaction;
f tender offer process (in the 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. Given the rapidly changing regulatory environment, the conditions for closing are frequently the subject of lengthy negotiations between seller and purchaser. One particular difference from other countries is that in Venezuela the purchase agreement is generally concluded 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 and political 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 make 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 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 immovable 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 favourable 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.

VI OUTLOOK

As Venezuela faces a major political and economic crisis, it has become a distress play for investors willing to bear a high level of risk and bet on a regime change in the foreseeable future or at least some change in government policies affecting the economy.
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Takenobu Imaeda is a partner at TMI Associates. He is qualified to practise in Japan. Mr Imaeda has extensive experience in a wide range of financial transactions, including project finance, acquisition finance and real estate finance, securitisation and other structured finance transactions. Recently, he has represented both financial institutions (mega and regional banks) and business operators in numerous project finance deals, including renewable energy power generation projects (e.g., wind, solar and biomass).

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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 that have taken place in Venezuela in recent years. Mr Italiani has been consistently ranked as a star individual for corporate/M&A by *Chambers Latin America*. He was honoured with the 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* has also stated that Mr Italiani ‘handles some of the largest financing and M&A deals in the country’ and ‘is particularly celebrated for
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Masakazu Iwakura is a senior partner at TMI Associates. He is qualified to practise in Japan and the state of New York.

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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 25 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 Business Law since 2006.

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Jerry is a regular speaker on REITs, business trusts, private funds, corporate governance and regulatory/compliance matters, and has published many articles. Jerry is fluent in English and Mandarin.

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He has worked on many initial public offerings of REITs and business trusts, as well as their subsequent acquisitions/disposals and fundraisings by way of secondary offerings, structured finance and convertible/perpetual securities offerings and regularly advises REIT and business trust issuers on post-listing regulatory and compliance matters.

He has also advised property developers, fund managers and other financial institutions on the structuring and establishment of private property funds.

Jonathan joined Allen & Gledhill after being called to the Singapore Bar in 2011 and has been a partner since 2017.
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He is involved in drafting documentation connected with the issue of shares, bonds and structured products. He advises on fundraising on capital markets, takeovers, the 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.
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Gustaf Reerink graduated from Leiden University, where he obtained an LLM in private law and an MA in Indonesian studies, and completed his PhD on Indonesian land law. 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 and acquisitions, energy and natural resources, and related regulatory and compliance matters.
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Paul Robinson was a Dublin-based M&A lawyer in the firm’s corporate group and had extensive experience advising on a wide range of corporate and commercial transactions. He was involved in a large number of high-profile acquisitions and disposals in the Irish market and regularly advised 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 transactions and acquisitions, joint ventures, private equity, limited partnerships and cross-border mergers and reorganisations. He advised numerous international clients on Irish acquisitions and had previously worked in private equity.

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He also has experience in the distribution sector, providing legal advice to both local and international clients in distribution and agency contracts, as well as in setting up corporate structures in this sector.

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The practice of Gints Vilgerts, LLM, is mostly focused on all aspects of M&A, corporate restructuring and real estate, and on complex commercial dispute cases.

In the course of practising in Latvia and abroad (Russia, Belarus, Lithuania and Estonia) for the past eight years, he has participated in more than 50 transactions of total deal size in excess of €2 billion, for clients from more than 10 jurisdictions. Gints Vilgerts has also been a guest lecturer at the Stockholm School of Economics in Riga, Riga Graduate School of Law and Riga Business School.
Gints Vilgerts is a Chambers Europe and The Legal 500 recommended practitioner in Latvia in the areas of M&A, corporate, real estate, construction and finance law.

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The Legal 500 (2012): ‘Excellent negotiation skills'; ‘Vilgerts has always been impressive, and his work remains equally so, chiefly due to the level of service and quality of output.’

Gints is included in Best Lawyers for Latvia in 2016, in the following practice areas: banking and finance law, corporate and M&A law, litigation and real estate law.

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She is involved in the activities of international associations, serving as co-chair of the Real Estate Committee of the International Bar Association, among other posts.

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