

Investing in UK commercial real estate

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CATEGORY:
[ARTICLE](#)



This note is addressed to investors and their advisers who are not familiar with the acquisition of commercial and mixed-use properties in the UK.

The UK commercial real estate market, especially in Prime Central London, is extremely competitive. Only those investors who have fully considered the steps in the acquisition process will have a realistic chance of their bid being successful.

Structuring and tax advice will need to have been taken in advance to avoid delay. See [Taxation of investment in UK commercial real estate](#).

Any borrowing will also need to be agreed in principle, if it is required for the acquisition. For this reason, many investors opt for a cash purchase and put borrowing in place at a later date if it is being only utilised in order to minimise tax on investment income and/or to amplify investment performance.

You will need to ensure that anti-money laundering requirements can all be satisfied at the outset.

We can help ensure that your bid is credible and its terms are deliverable. An offer letter from solicitors also adds weight to your bid.

The process

Investment opportunities may be sourced through a variety of intermediaries but we would always recommend that a chartered surveyor who specialises in commercial investment agency should be retained to advise on the commercial terms of any acquisition. They will be familiar with the issues which have to be taken into account over and above the headline yield. They can also advise on the best strategy to acquire the building including the terms of any bid letter.

As a new entrant to the UK market, you may have limited evidence of a 'track record'. In any event, it may be necessary to provide evidence of the availability of funds.

Arranging for your surveyor/solicitors to carry out a preliminary due diligence review of the target property will give your bid additional credibility, ensure that there are no major 'deal breakers', and so reduce the risk of abortive fees.

Typically, a buyer's fees are 6.5 – 7% of the purchase price (stamp duty land tax plus agency, legal and survey fees).

Once a sale to you has been agreed in principle, relatively detailed but non-binding Heads of Terms will be drawn up. The input of an experienced commercial property agent and lawyer should be sought when these Heads are negotiated because the seller is likely to resist strongly any later attempt to vary or depart from the agreed Heads.

They should be sufficiently detailed to give the parties' solicitors all the commercial information they need to prepare the transaction documentation.

If desired, we can recommend agents/surveyors best-placed to advise according to the profile of your desired investment.

A binding contract will generally be required to be entered into within approximately 20 working days of Heads being agreed. Diligence, negotiations and reporting then have to be conducted within a tight time-frame. Property searches usually take between 10-15 working days. Issues will be drawn to your attention as they arise; regular and close liaison between the investor and the advisory team is essential during this period.

A 'lock-out' or 'exclusivity' agreement may be desired together with some form of 'non returnable' deposit (similar to an 'escrow' deposit), but it is more common to move directly to progressing the deal itself, with most sellers honouring the time-frame agreed in the Heads of Terms.

Much has to be achieved in a short space of time, in particular:

- **Structuring:** this should be finalised at an early stage and the identity of the acquiring entity confirmed. If a leasehold interest is being acquired, accounts and references will need to be supplied at short notice in relation to the acquiring entity or (in the context of the acquisition of a leasehold interest) any guarantor. Note that accounts and references for any overseas entity will need to be available in English.
- **Due diligence:** this will involve: reviewing all of the title documents to the property; reviewing and reporting on any occupational leases; making all relevant searches (including in relation to town planning and environmental matters) and reporting adverse search results. The seller will usually provide replies to standard enquiries ('CPSEs') which will give information about the property including: details of occupier's arrears; service charge accounts; insurance cover; employee information; VAT status; and capital allowances history. In the UK, title insurance is not generally available.
- **Legal opinions:** where the buyer or the seller is a non UK entity, a legal opinion will need to be obtained evidencing its ability to enter into the transaction.
- **Gearing:** if borrowing is to be utilised (whether to finance the purchase or to reduce tax on income / amplify returns), the lender will instruct its own solicitors to conduct an independent diligence exercise. (This contrasts with residential acquisitions where the same solicitor typically acts for both buyer and lender.) This can cause delay and inevitably leads to some duplication of costs. Ideally, the lender's diligence exercise will be completed before exchange of contracts. However, borrowing is often finalised after exchange and this highlights the need for a thorough diligence exercise so that nothing comes to light later which could cause the lender to withdraw its loan offer.

The lender will also want an independent valuation report which will take a week or more to be prepared.

- **Survey(s):** a surveyor's report (and perhaps other specialist surveys) will be needed to check that there are no issues with the physical condition of the property or plant which will impact on its investment value (see below).
- **VAT:** the acquiring entity will usually have to register for VAT and 'opt to tax' ahead of the deadline (see below).
- **Sign-off:** the practicalities of sign-off on the transaction need to be considered. Board approvals may be required in which case the likely whereabouts of signatories will need to be checked. Original signatures will be required on the completion documents but in some cases may not be needed to achieve exchange of a binding contract. A legal opinion will generally be required for a non UK entity.

'Income stream'

The investor will almost invariably be acquiring the property for its actual and potential income generation, as well as its potential for capital growth.

This means that different tax considerations will impact on the choice of holding entity and, if required, we can advise on the most tax-efficient structure.

If the interest being acquired is leasehold rather than freehold, we shall review the terms of the 'investment lease' and in particular the rent payable to the freeholder/superior landlord. Such rents may be notional or may be substantial, often taking the form of geared rents representing a percentage of the market rental value of the lettable space (not necessarily a percentage of the rent actually received). Equally, they may be a percentage of capital value subject to periodic review.

The consent of the landlord to the acquisition of the leasehold may also be required.

The occupational lease(s)

The target investment may be let to a single occupier or it may be a 'multi-let' building. In the latter case, the investment involves acquiring the reversion of a portfolio of leases. These leases are key to the performance of the investment and the diligence exercise needs to be carried out with a clear focus on what issues could impact on investment value and a lender's willingness to accept the property as security. Any assumptions on which internal rates of return, net present values or other investment criteria have been based need to be verified. These assumptions will be legal, physical and economic. We can advise on the legal issues and, where appropriate, comment on the other aspects of the diligence exercise.

It goes without saying that we will scrutinise the rent and rent review provisions for any unusual wording or 'assumptions' (for example, as to whether historic improvements can be 'rentalised' at review) as this can have a major impact on capital value and yield.

These leases are usually between 10-15 years, but may have 'break' clauses in them. The tenant will usually be liable for the cost of repairing and insuring. This is known in the UK as a 'FRI Lease'. The repairing and insuring responsibilities will either be the landlord's (with such costs recharged to the tenant) or the tenant's directly.

The investment value of each lease will need to be assessed in terms of financial performance, length of unexpired term(s) (and the likelihood of any right to break being exercised) and the status of any guarantors or former guarantors. This assessment depends on legal factors as well as the financial performance of the entities concerned. For example, the analysis of covenant strength will be different for any lease granted before 1996; in those cases all former tenants and their guarantors are likely to remain liable unless they have been released – possibly inadvertently by a subsequent variation of the lease.

Expenditure needs to be considered as well as income receipts. Every investor wants to minimise costs in order to maximise returns. It is essential, therefore, that we check the extent to which it is possible to make full recovery of the costs of providing landlord's services. (The burden

of service charge and 'empty rates' needs to be factored into projected rental 'voids')

Property-specific tax issues – stamp duty land tax (SDLT)

SDLT is charged in bands rising to a top rate of 5% on the element of the purchase price over £250,000. On a high value acquisition therefore, the rate will be marginally less than 5%. It is payable by the buyer. (The purchase price will include any VAT, but fortunately this 'tax on tax' is rarely levied for the reasons given below.)

SDLT will be payable within 30 days after 'substantial performance' of the transaction, which is usually completion.

If a non-UK property holding company (as opposed to the real estate it owns) is sold, no SDLT or stamp duty will be payable. If a UK property-holding company is sold, stamp duty at 0.5% will be payable. However, such transactions are relatively rare in relation to commercial real estate.

Value added tax ('VAT')

VAT at 20% may be charged on the purchase price of commercial or mixed-use properties. This will be the case with new buildings and those where the seller has 'opted to tax'. In cases where the sale is subject to VAT, there will be little practical alternative other than to 'opt to tax'. That will often have the effect of making the sale itself VAT-free (and consequently mitigating the SDLT payable).

Where there is no immediate need to opt to tax, you should consider the best strategy for the property as a whole, taking into account future expenditure plans and the likely tenant-mix profile as some tenants will not be able to recover the VAT paid on rent.

Capital allowances

It is not unusual for the seller's 'capital allowances' to be transferred, in whole or part, to the buyer. These are 'writing down' allowances against taxable profits in respect of historic capital investment in plant and machinery. The allowances are at the rate of 18% a year, with an 8% rate applying to 'integral features', and generally have effect on a 'reducing balance' basis. Each year the allowance is applied to the balance of expenditure after deduction of previous years' allowances, for example the 18% allowance is applied to 100% of the qualifying expenditure in the first year but to only 82% of the expenditure in the following year and so on. This means that around 75% of the expenditure is 'written down' over the first seven years.

On the sale of a property, the seller may well wish to retain any unused capital allowances. However, where the buyer would be able to benefit from them more than the seller, it may make more commercial sense for the seller to pass them to the buyer, generally for additional consideration.

Assignment of contractual rights

If a building has been developed or refurbished in the past 10 years or so, we will need to deal with the transfer of rights in relation to the contractor's warranties and those given by the development professionals.

In addition to the construction documentation, we may be required to review and report on all the other contracts relating to the servicing of the building to establish which are capable of being novated or assigned to the investor and which may be terminated.

Physical inspection / survey

No warranties will be given by the seller in relation to the physical condition of the property and so time will have to be allowed for survey and perhaps other specialist reports to be produced. As well as considering the structural integrity and condition of the building, a survey of commercial premises will also need to consider such matters as the possible presence of deleterious materials and asbestos, statutory compliance, escape rights over neighbouring property etc. We can make arrangements for a surveyor to report on the property and help you in assessing the conclusions of the report.

There are, of course, many other facets to commercial real estate acquisition such as investigation of the planning status of the property, service charge and arrears issues, pending claims and lease renewals, sub-tenants' occupation terms, etc and so this note is merely intended to give an overview of some of the main factors that an investor new to commercial property may not have previously encountered.

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