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thinking

Real Estate

ISSUE THREE

Contents

Welcome to the latest edition of Thinking Real Estate, where we aim to share our expertise and ideas with you to support growth and sustainability for your business.

In this latest edition, we're focusing on some practical issues affecting various parts of the sector:

- Mid-market retirement – the UK market is behind the curve in providing comfortable, affordable property for the 'Last Time Buyer', but times are changing, and the Kiwis are taking the lead.
- Intellectual property – IP rights might not be at the top of the agenda in real estate transactions, but can be vital, especially if they're overlooked when a shopping centre is sold.
- Real estate finance – are property values in London topping-out, and if they are, how is this going to affect the residential market in the capital and elsewhere?
- Hotels – leaving the EU means uncertain times for most businesses, but perhaps the UK's hotel sector has more to gain than most.
- Shared ownership – solving the UK's housing crisis will involve thinking about new structures around equity and affordability.

We hope you're enjoying Thinking Real Estate – we've written it in the way we like to talk to our clients – unstuffy, pragmatic and real conversation. So, please get in touch with us directly at thinkingrealestate@trowers.com with any questions or comments, and follow us on twitter @Trowers.

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HOTELS PONDER THE BREXIT QUESTION

Amid all the ‘unknown unknowns’ of Brexit (as former US Secretary of State Donald Rumsfeld might have had it), the UK’s hotel sector – an estate worth around £25bn in total according to figures from the Investment Property Forum – may have the hardest challenge in reading the runes.

“The UK hotels sector is facing a period of real uncertainty,” says Julien Allen, partner in Trowers & Hamlins’ London office, “but it’s far from doom-and-gloom at the moment. What it is, though, is very tricky to get an accurate and verifiable handle on. There are so many moving parts that we’re not alone in finding the future hard to predict.”

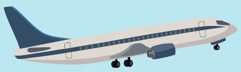
“The sector was already a little off its recent peak (which occurred in 2014, according to a report by the Hospitality and Leisure group at accountant PwC),” he explains, “and because the value of a hotel, in the longer term, is essentially a function of its occupancy – assuming good management of course – if that was to turn into a sustained downturn, that could prove problematic for investors.”

Allen sees the greatest possible challenge to the sector as a result of Brexit is on the employment front. “The sector is very heavily-reliant on low-cost, multi-skilled labour from Europe,” he says. “If people choose to go back to their country of origin, or are dissuaded from coming here because they don’t think they’re welcome, that is going to exacerbate recruitment shortages hotels are already experiencing and inevitably push up operating costs.”

“That will put pressure on the management agreements, and that in turn will mean a squeeze on institutional yields from the sector. That in turn could reduce sector values and reduce the availability of finance. We could – in the worst case - be looking at a Brexit ‘crunch’,” he concludes.

Increased pressure in the sector could have other consequences, though. “A crunch of this kind is likely to hit the least agile operators hardest,” warns Allen. “Single hotels, especially in the upper mid-market and even at the ‘trophy’ end are vulnerable because they have no way to defray management costs. Small, undifferentiated chains will also face a challenging time, but this could lead to a few distressed opportunities for institutions looking to invest. We could have a bit of a shake-out in the sector.”

He also sees opportunity in regional devolution, where Trowers & Hamlins – with a longstanding reputation in the public sector – is heavily-involved both on the regulatory side and in commercial ventures.



“Airport City Manchester is one of the key components of the North West development project,” says Allen, pointing to one example where Trowers has been active of late.

Hotels will be central to the new, £800m ‘urban quarter’, which is the first major infrastructure development in the UK to involve equity investment from China. “One new 480-key hotel is planned next to the airport itself,” he adds, “though we expect it’s going to be the first of several, to meet increased demand related to the new direct flights from Manchester to the Chinese mainland.”

Allen believes the government should give specific support to the hotel sector as the UK’s new role in the world becomes clearer. “A decision has been made that the UK should carve more of an independent role on the world stage,” he says, “and a large part of that is going to be opening up new export markets and encouraging new foreign investment. Having a top-end hotel sector, able to host at a high level of quality close to transport hubs and to key areas for investment will be a vital part of the jigsaw. We have a lot of experience in helping stakeholders among investors, operators and local authorities to deliver landmark projects but – to paraphrase again – the hotels of Rome were not built in a day!”

IS THERE A DEVELOPMENT FINANCE 'SQUEEZE'

The UK is an interesting place at the moment in terms of property development. To the outside observer, London – which accounts for the lion's share of new development, and where the most attractive returns are to be found - seems to be a hive of activity; full of cranes and construction trucks with towers sprouting in every neighbourhood.

But as values have reached and exceeded £1,000 sq ft for residential property developments in the capital outside the prime locations, the big UK banks – which together account for over 75% of all debt finance across the UK property loan book nearing £250bn – are starting to fall away.

"At this level of valuation," explains Simon Owen, banking and finance partner at Trowers & Hamlins, "all parties are looking more carefully at the risks of the project and whether, in particular, there is a sufficiently deep market for the end product to sustain the prices that drive these valuations."

Owen points to one scheme the firm is active on, in an up-and-coming area of town, where values are in the £1,000-£1,300 per sq ft range. "The developer is experienced and has a very robust view," he says, "they are willing to weather difficult market conditions, but at these levels, there is a lot of additional nervousness."

Pressed by valuers, who are being more conservative as the super-heated London residential property market cools, developers are having to put in more equity, something that has caused a few to think again.

"Valuers are understandably cautious, especially when prices are at such historic highs," says Owen. "If they get things wrong on the residual land value then they could be liable for losses incurred by investors down the track. But passing the risk on to developers is causing difficulty because they can't raise finance easily from the main lenders, who are very cautious about property assets after the last financial crash."

Although average debt ratios are significantly lower now than back in 2009/2010 reflecting higher equity contributions across capital structures, and notwithstanding the upturn in real estate debt funders entering the market, particularly the so-called non-bank lenders, the development finance market remains relatively shallow in comparison and development finance is more challenging to source. That said there does seem to be an increase in providers of development finance at the lower debt levels particularly sub-£5m.

"What we could be looking at, essentially," says Owen, "is the start of a development finance squeeze above a certain price threshold outside super and prime locations. Funders are looking to reduce and preferably eliminate the market risk in their deals."

Other relevant factors include the influence of lengthy planning procedures which delay developments; continuing construction risks including skilled labour shortages, materials and machinery shortages; and, of course, the impact of Brexit.

"It will take years for the effects of Brexit on the property market to be properly assessed," notes Owen. "but it does seem that lenders are increasing margins to compensate in the post-Brexit environment, also executing development finance transactions takes a long time, given the number of moving parts, something that's been true for a while now. We know of a number of deals that have been running for well over a year, as lenders are keen to dot every 'i' and cross every 't', but that's the environment you have to work in."

Ironically, for a market that prides itself on flexibility, free market principles and the dominance of private capital, it is quite possibly going to be government that provides a way through the logjam, according to Owen.

“Central government has the ability to oil the wheels of the system in a number of ways, yes, but that won’t solve anything quickly,” he says. “We suspect it is at the local government level that we are likely to see real change happening. Not only can local authorities borrow from the Public Works Board to fund new housing development, but perhaps more importantly they can help bring public owned land to market, co-ordinate schemes and have some room for manoeuvre on planning.”

“It may be this return to a more localised approach, particularly in the regions, will also help bring back the small and medium-sized housebuilders who have been a major casualty of the banking crisis, and hence more flexibility and more lending on smaller projects,” he adds. “Though that layer of the market will take a long time to rebuild to anywhere approaching historic size!”

Trowers & Hamlins’ longstanding involvement with local government, particularly on housing and infrastructure, means the firm gets to see things from every angle, acting for local authorities and the HCA as well as private developers and funders with substantial experience on all sides and a detailed understanding of each parties’ particular sensitivities. “Our experience is that it does seem to make transactions rather easier to navigate for our clients.”

Owen is guardedly-optimistic about the future for development finance, as long as the current valuations issue can be sorted. “This does need work,” he says. “Most of the new non-bank lenders in real estate aren’t generally active in pure development (with a few notable exceptions, including the likes of Urban Exposure), as development risks don’t work for them, and the UK market remains dominated by the big lenders who have their own concerns.”

“There are clearly ways through the current challenges, but it is going to require market participants to think a little more creatively.”

What's buried in your head-lease?

The advent of the digital age has transformed the retail sector and the consumer experience. Shopping centres, with a higher preponderance of retail chains as occupiers, have faced perhaps the most serious threat – why bother to go to a centre when you can reliably get all the same products online from the same retailers, with no risk of them being out of stock?

The industry's solution has been to transform the workaday shopping centre into a 'destination', complete with restaurants, cinemas, leisure facilities, gyms, spas and even hotels. Most cities in the UK now have at least one 'retail destination', such as Birmingham's Mailbox, Sheffield's Meadowhall, The Light in Leeds or Westfield's two massive shopping centres to the east and west of central London.

But as Caroline Hayward, partner at Trowers & Hamlins, explains, the property in a shopping centre isn't just limited to the bricks-and-mortar kind.

"When an investor buys a shopping centre, typically they just see it as real estate," she says. "There is one key document for the transaction, and IP (intellectual property) is buried somewhere in there. Of course IP is not the prime consideration for the transaction, but there are all kinds of issues, which if they're not spotted at the time, can be tricky and expensive to unwind further down the track. A shopping centre is a going concern, so you need to make sure you own all the IP assets relating to it."

That means making sure all IP rights owned by the seller are assigned on any acquisition, but it also means ensuring that you own all the rights which are key to the centre's business.

While this may seem obvious, it's amazing how many times IP ownership is overlooked, according to Hayward.

"I can think of one instance where the owners of a shopping centre wanted to change their marketing agency," she says. "The problem was that the agency owned the domain name for the centre, and they refused to hand it over. We managed to get it eventually, but it cost time and money to do it, and it's the kind of hassle you just don't need."

One common issue in these days of freelance graphic designers, is hiring a designer to knock you up a logo, corporate identity and even a website thinking you'll own the rights because you paid the bill (hint: you don't, copyright remains with the designer unless specifically assigned).

Another issue is making sure that your existing trade mark covers everything your shopping centre currently provides.

"Until relatively recently, 'shopping centres' were not recognised as a 'service' capable of trade mark protection. That changed with a High Court challenge, following which shopping centres are permitted the same sort of trade mark protection as is afforded to department stores and other shops which sell a range of third party products.

"The importance of this is not only that you don't want someone else to use the same name as your centre for their own shopping centre, but that you don't want them to use the name for the same sorts of facilities and services contained within your shopping centre – in other words, if you are, say, Westfield shopping centre, you don't want a department store called Westfield to open up opposite your shopping centre any more than you want an 'unauthorised' Westfield shopping centre."

Hayward's advice is to not think of the IP in a transaction as a single issue.

"IP is about constituent parts," she explains. "And if you widen the coverage of your mark, as one might do in transforming a shopping centre to a leisure destination, you widen the scope of businesses you might want to object to which may be damaging your brand."

One complicating issue is where the going concern comes to denote a geographic location, say for instance London's Canary Wharf or Borough Market. Trade mark rights can be lost in these circumstances, where the name becomes the same as the locality. The result is that - as happened to Canary Wharf Ltd – your trade mark can be cancelled.

But there are still things to consider when commercial exploitation of IP assets might not even be on the agenda.

> **"Quite often the owner might not even be aware that the name or logo of the shopping centre is protectable as a trade mark, or they may not have had the domain name, or the copyright in the logo, assigned to them. The primary function in the eyes of the business is not to hold and protect IP assets, but it may be detrimental to the tenants of their shopping centre if they don't."**

HOUSING ASSOCIATION IP GAPS?

Shopping centres are not the only part of the property industry where an extension of scope has had knock-on effects where IP is concerned.

"We as a firm act for a huge number of housing associations," says Caroline Hayward. "Some of them are very longstanding organisations, which may have no trade mark protection at all, or they may have a registered trade mark which was filed many years ago. If there is a registration, it may just cover 'housing services', but the role of housing associations has grown to cover a wide range of ancillary services, such as job search advice, or help with independent living."

"Your trade mark needs to cover everything that you provide. It may suit a private careers consultancy offering job search advice, or private companies offering building and construction or repairs services, to use your name or use very similar-looking IP assets, colour, logo etc, to imply you're connected, when you're not. Vulnerable people are very likely to be taken in by this kind of ruse, and that's exactly what you don't want, so make sure you are correctly covered."

The untapped promise of mid-market retirement housing

You may not have heard of 'Last Time Buyers' (LTBs), but they are over 55s in the UK who might look to downsize their property requirements going into retirement.

There are 3.3m of them, and they're sitting on assets of £820bn, according to the Centre for Economic and Business Research, and highlighted in a report – 'Free Up Housing Stock' – by financial services provider Legal & General in 2015.

Currently, though, most of them are going nowhere. For many that is because they don't want to move and never will. But for those that do it's mainly because there's nowhere to go.

"Older people's housing in the UK has traditionally been focussed on social or affordable provision, councils and housing associations. There's also a small amount at the very top end. The whole market is underserved but the mid-market has been particularly neglected," says Kyle Holling, projects partner at Trowers & Hamlins and co-head of the firm's market-leading Health & Social Care team.

"We're talking about the average homeowner in the UK, maybe in a three or four-bedroomed house, perhaps looking to downsize but not necessarily downgrade. Downsize is perhaps not quite the right word either - we hear "rightsize" used a lot. This is not about the size of the accommodation but about an offer which better suits people at the time they are looking to move and anticipates their future needs too. As yet, there's very little available in terms of what we might call 'aspirational' product out there, so a lot of people are staying put."

So what might this aspirational housing look like in practice? Well, think retirement villages of up to 350 units, or specialist apartment blocks, providing comfortable living with a range of services, a sense of community and care element.

"The care element in this kind of project is a de minimis onsite unplanned reactive service," explains Holling, "which means there will be someone onsite for emergency situations, with services also designed to meet occupiers planned care needs as required. "

Holling, a Kiwi by birth, points to the New Zealand market as an example of what might be possible in the UK. "The New Zealand market is in many ways about 20 years ahead of the UK in this respect," he says. "There is every reason that this should work in the UK, the demographics are right and as the L&G report shows, there are millions of homeowners who have benefited from rampant growth in house prices, but who are now living in properties which don't meet their current needs in some way. Sometimes this is about the home being too large and challenging to manage physically or financially. But there is also evidence around social isolation and the benefits on health and wellbeing - including savings for the NHS and social services - of the sort of environment which a good retirement community can create."

Those larger properties account for 7.7m spare bedrooms, according to the L&G report, or 10 years' worth of housing supply based on government targets (double that in terms of current completions).

"It's not a panacea," cautions Holling. "Maybe five in a hundred people will want to go into this kind of housing, so 5% of the market. That may not sound like a lot, but the current provision is around 0.3%, so there is a lot of untapped demand."

One of the main obstacles to date has been the law. Standard procedure for a number of established operators is to discount service charges or other costs to residents in order to maintain affordability and to recover that discount from housing equity on the resale of the unit. In other countries this "use now, pay later" fee can be up to 30% of the equity in the property.

While this model is used here in the UK a 2012 report by the Office of Fair Trading – not directly related to the retirement housing with care market – cast doubt upon the enforceability of what are known as deferred charges or exit fees. The Law Commission has labelled these "event fees" and is currently working to clarify the situation.

The removal of any legal uncertainty is, of course, vital to creating a positive investment environment, but it's not a market for every investor.

"If your revenue is based on units changing hands, for older people's housing there is a reality that to some extent (though far from exclusively which seems to surprise many) you are recovering from people's estates after they have passed away. So you have to understand the demographics," says Holling. "There's an issue around developments taking time to get to a steady state with an expected number of changes of resident each year, and also an issue of scale within a wider business and, for example, managing the average age of residents across that business.

Much of the activity in this part of the sector so far has come from third sector organisations such as ExtraCare Charitable Trust. This Trowers client supports over 4,000 elderly people in 17 housing schemes and 14 villages, and its five-year strategy includes a £200m plan to complete five housing villages in the Birmingham area.

"We are definitely seeing interest in the mid-market from a number of sources" says Holling. "The not-for-profits are moving toward it from the affordable end, while the higher-end providers are moving toward it from that end. They are already sector players and understand the business models and the demand drivers for buyers. We are also seeing interest from established providers in the care home market and from those in the hotels and leisure sector".

Tim Nye, partner in the firm's corporate department, and a specialist in private equity, thinks other investors can benefit but need to modify their outlook.

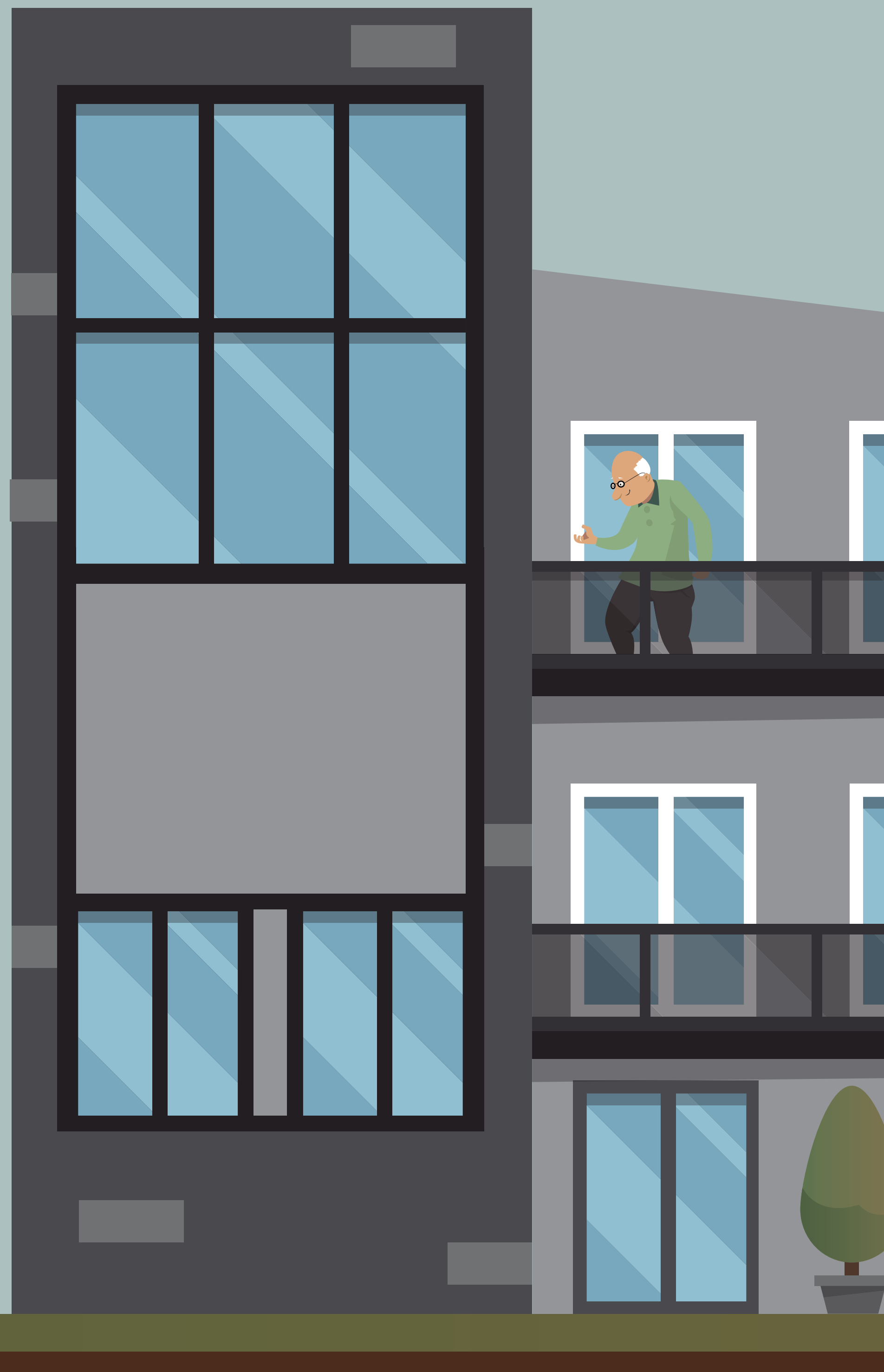
"The investor timescale on this kind of development is 10 plus years before you see predictable returns," he says. "That's too long for traditional private equity investors, it doesn't necessarily work for the banks, and pension funds only think in terms of fixed yields not the lumpy type payments that these developments throw off at the start. This requires a different investment mindset."

Nye welcomes the move to clarify the law. "Clearing up uncertainty around deferred management fees will settle investor concerns," he says. "It will mean the deferred management fee can form part of valuations because as its applicability becomes more certain and this makes the whole concept of the deferred fee much more bankable, from an investor point of view, and will lead in due course to a secondary market, when there are many more units around."

Nye also thinks the offering (as well as the price) is central to the success of retirement villages. "The focus for the mid market is on creating a great living environment with good facilities which aren't going to break the bank for residents," says Nye. "As an operator, it's up to you what you put on the site, you may have a cinema, gym, a bowling alley, restaurants, however the key is availability of use, not its uptake; no one nowadays really wants organised entertainment or forced activities and operators in planning their villages and packages should bear this in mind."

Larger developments are very much the norm in other places such as New Zealand, Australia and the US and, along with infrastructure, can be a powerful driver for urban regeneration too.

In the UK, the team feels it could also be an attraction for local authorities looking to develop moribund town centres. "The story goes that as you got older, you'd want to move out to the country," says Holling. "But increasingly, the evidence shows that people would rather be in a more vibrant community with good infrastructure, close to good facilities. There's a great opportunity for local authorities to think about how retirement living can be incorporated into their strategic plans, and to work with the NHS, which is looking to make better use of its estate."



Institutions ready to consider Shared Ownership

Housing is now near the top of the political agenda, and in a market where investors are searching hard for good returns, it is increasingly in the sights of funds and institutions, which wouldn't have looked at it in the past.

But the mix of market issues, complex demand and unpredictable political involvement can make it a tough prospect to read accurately

"On its face, housing should be a good investment," says Ian Graham, head of Housing and Regeneration at Trowers & Hamlins. "There is a huge amount of demand, a willingness to get things done at government and local authority level, and public subsidy available in a number of different schemes. But investors and developers need to look at the whole picture."

Graham sees a shift in the market towards Shared Ownership schemes, prompted by last year's Autumn Statement announcements of major Government investment in this area. "I think the focus of policy is changing with new ministers appearing to be more flexible in their approach to housing and less single minded about promoting home ownership," he says. "That said, I don't see a complete reversal of last year's announcements and so shared ownership will still be important. The Help to Buy equity loan scheme for first time buyers is to continue and has been very popular, but it doesn't help everyone. There are still those for whom shared ownership is a more attractive and accessible proposition.

"Trying to create new products as an alternative to, or a variant on, shared ownership is very difficult. If the scheme involves access to mortgage finance for the purchaser (not all schemes do) then you run into problems because mortgage lenders are unlikely to want to change their systems to adapt to the new scheme. There simply isn't the volume of business to justify it... Shared ownership is an established product and one lenders understand. It is also a good route into solid, if perhaps a little unexciting, income for investors."

The principle is tried-and-tested: the occupier buys a stake, usually 25%, on a mortgage basis (needing only a modest deposit) and then pays rent equivalent, typically, of up to 2.75% of the capital value of the remainder to the landlord investor. The investor gets a reliable index linked income-stream and benefits from any capital uplift in the property.

"A key advantage to the landlord investor over PRS (private rented sector)," explains Graham, "is that there are no voids, you're getting 100% occupancy with Shared Ownership. There is also no cost to the landlord investor for repairs/insurance. These are covered by the shared owner unlike a PRS scheme. There is a risk that the shared owner might buy out your equity at any point (this is called staircasing) and that will bring the rental stream to an end. That's not what a long term investor wants but the problem can be mitigated by reinvesting the proceeds generated in another shared ownership unit."

"The unpredictability of staircasing does complicate things when it comes to the secondary market," he adds. "If you have a portfolio of properties each of which, at any time, might see the occupiers buy you out, it complicates valuations, and of course any securities based on that book."

"But in general terms, if you're a big institution and looking for a long-term, stable return on your asset, and you can get your head around the valuations on a sizeable book, Shared Ownership is a great idea."

Suzanne Benson, partner and housing expert in Trowers' Manchester office, says the key thing investors need is understanding of Shared Ownership. "They may understand PRS, but this is different," she says. "Some investors may not even realise they can do it, legally, given that it's traditionally always been associated with housing associations".

Benson puts Shared Ownership firmly in the context of the broader plan of the Homes & Communities Agency (HCA) – responsible for housing everywhere outside London – that is trying to create a level playing field between housing associations and private developers.

The HCA's Prospectus outlines a five-year shared and affordable homes strategy with £4.7bn of government money behind it.

"We're waiting to see further details on the response of the market to the Prospectus – initial signs are that very cautious bids have been submitted so far" she says. "The HCA isn't looking to allocate the full pot immediately, but the first tranche will be very telling in terms of who wants to invest in what kind of scheme, and which developers will be involved."

"It's very important that none of the actors in this area think that one size fits all," says Benson. "Shared ownership can tend to work better in some markets and may struggle in others. Areas with particularly high or low values have historically struggled to maintain the product. Current market commentators however claim the success of shared ownership is better considered on a site by site basis."

In considering new entrants to the market, Graham points to some enterprising local authorities which are setting up housing companies funded by their ability to borrow cheaply from the Public Works Board. "It's great for them because they can get hold of the money to build quite cheaply, and then get a reliable income stream from PRS, social or Shared Ownership homes, and address local housing need."

"Some don't have the skills to do this, having lost them when social housing was taken out of their hands in the 1980s and 1990s, but just as important is the courage to try some of these things."

Graham points to Cherwell District Council, which has launched a project called 'Build!' at Graven Hill near Bicester, a popular commuter town in Oxfordshire. This self-build project aims to create 1,900 homes over a ten-year period on old Ministry of Defence land.

"Self-build isn't going to be for everyone," says Graham, "but it's part of the kind of diverse strategy that housing in the UK really needs. The days of one-size-fits-all housing policy are long gone, or should be. It is that kind of thinking which has been holding back housing provision."

"Local authorities certainly understand they can do things like this," says Suzanne Benson, "but many of them lack the confidence to do it."

Graham agrees, adding that government needs to give local authorities a more stable commercial framework in which to operate. "There was a big settlement when we moved to ring-fenced Housing Revenue Accounts for each local authority," he explains. "That did create a bit of headroom for councils, but then a few years later the government imposed a four-year 1% rent cut on them. All the business plans which had been based on the original settlement had to be torn up."

"It is a tough environment, for local authorities, managing within that strait-jacket, but if they can get the right advisers on board and the right skills in-house, there is still some room for manoeuvre and an increasing number of big investors looking more carefully at the potential offered by housing."

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