

# Practice & Law

## SPECIALISING IN SUCCESS

**Investment** Simon Rutman and Sarah Quy explore how investors can reap the rewards of diversifying their property portfolios into specialist sectors



**D**espite some anxieties around the high-end residential property market, which is adjusting to recent tax changes, and uncertainties regarding the UK European Union referendum on 23 June 2016, the UK real estate sector continues to attract both domestic and overseas investment. Pull factors include high occupier demand and low interest rates as well as transparent and secure markets, and the UK has also benefited from relative instability in the eurozone.

The majority of the recent gains made by the real estate sector are a product of a

combination of yield compression and rental growth. Some investors believe that the scope for further yield compression is now limited. This and the often intense competition for assets in certain parts of the market can make it very challenging to find new deals which will provide a repeat of the level of returns enjoyed in 2015. Some investors are therefore venturing outside the traditional office, industrial and retail sectors.

### What are the specialist sectors?

The specialist property sectors are varied

and distinct but investors in them usually have a deep understanding of the business operating from the properties that they buy, which is fundamental because they will often become directly involved in that business. Among the currently popular niche sectors are:

- waste management sites;
- the private rental sector;
- gyms;
- health care sector generally, but particularly care homes;
- student accommodation;
- retirement accommodation;



PHOTO: US/IN/REX/SHUTTERS/STOCK

### Diversification

One impact of the credit crunch of 2007/8 and the resulting recession has been an increased awareness of risk and of the wisdom in investing in a wide range of sectors whose returns are complementary and independent of each other.

Some investment types carry relatively low risk; for instance, student accommodation (which is multi-tenanted and often benefits from parental guarantees) and car parks. A number of successful London listed funds investing in student accommodation have been launched in the past few years.

Others help the investor hedge against inflation, such as rents in the premium car dealership market, which are often linked to the retail price index or similar indices. Others are linked to the profitability of the occupier's business; for instance, in the hotel and care homes sectors initial rents are often set at an agreed percentage of sustainable earnings before interest, taxes, depreciation and amortization.

In others the investor will directly benefit from the success of the business being carried out from the property because it is invested in the operating business (as is often the case with care homes) or because it has employed professional managers under a management agreement (as is common within the hospitality sector).

### Growth opportunities

Some investors are looking for investments to which they can add value. In a very transparent market it can be difficult to find opportunities where this upside is not already priced-in and it is hard to achieve added value through asset management of a fully-let long-income building.

### Long-term income

In a year which has begun with a great deal of uncertainty, investors are attracted to the long-term opportunities provided by, for example, an ageing population or a student cohort which is increasingly unwilling to live in multi-occupied houses.

### What does this shift say about investors' changing business plans?

Investment risk in the specialist property sector can be seen as a spectrum ranging from straightforward ownership of a tenanted freehold property at one end,

- petrol stations and service areas;
- hotels; and
- self-storage facilities.

### Why are investors attracted to these specialist sectors?

#### Yield

As demand for property-based investments has intensified, prices across the traditional real estate sectors have risen and yields have fallen. Investors have therefore had to find alternative approaches. Some have turned to secondary assets while others have chosen to invest in specialist properties.

## inside

### Planning notes

Court of Appeal judges are increasingly unwilling to quash planning approvals

PAGE 83

### Regenerating Croydon

Insights on securing a timely compulsory purchase order

PAGE 84

### Practice points

Overly restrictive plan allocation was unlawful

PAGE 86

### Completion complications

Issues that arise in respect of apportionment of service charge

PAGE 87

### Permitted developments at risk

What is the position for partially completed developments ahead of the May deadline?

PAGE 88

### Legal notes

Property professionals should exercise caution when providing professional assistance to friends

PAGE 89

### Case summaries

*Cocking v Eacott, R (on the application of Jedwell) v Denbighshire County Council*

PAGE 90

## ONLINE THIS WEEK

**LAW REPORT** The Estates Gazette Law Reports are now available exclusively on EGI each week and in bound volume three times a year. This week we report *Purewal v Countrywide Residential Lettings Ltd.*

through assets like freehold hotels subject to hotel management agreements and franchise agreements to, at the other end, investments such as freehold hotels run by the investor's in-house management team.

Some property investors have always accepted an element of business risk; for instance, traditional turnover rents in shopping centres are not uncommon, and similarly property investors who build speculatively are used to taking a view on the business demand for their product. So for some the move to the specialist markets is not a difficult shift, because switching from focusing exclusively on tenanted freehold office buildings to buying a freehold gym subject to an operating lease is little more than diversification.

An additional consideration is that in many alternative real estate investments the investor benefits from two separate stakes: the underlying real estate and separately the business occupying the premises. The awareness of underlying land values is not new, nor is it exclusive to specialist sectors, and landbanking has been an accusation levelled at businesses such as supermarkets and residential developers.

Perhaps as a result of the scarcity of land, the UK has a well-developed and sophisticated specialist sector which is expected to continue to grow and to draw in further investment during 2016.

*Simon Rutman is a partner and Sarah Quy is a professional support lawyer at Travers Smith*

## WHAT DO SPECIALIST INVESTMENTS MEAN FOR REAL ESTATE FUND LAWYERS?

The sorts of legal issues that are prevalent in this changing investment pattern include:

- Advising on the structure of the investment:
  - Investments are often made through joint venture agreements, which can be complex, although English limited partnerships continue to be one of the most common structures for private collective investment in UK property for sophisticated investors.
  - The establishment and running of real estate investment trusts is increasingly relevant to the real estate sector, in particular for retail funds investing in the UK.
  - Many alternative investment transactions use the "opco/propco" model, which separates out the property ownership from the daily management of the business, and which provides scope to enter into sale and leaseback transactions involving new institutionally acceptable agreements for lease and leases.
  - Franchise agreements and/or asset management agreements – depending on the parties involved, the property owner and the operator of the business, will often need a detailed agreement setting out their respective obligations and risk/reward allocation.
- Tax advice often plays a key role in comparing possible structures and also the transaction as a whole.
- Acquisitions and disposals in this sector often look more akin to business sales than real estate investment transactions.
- The management team's terms of engagement can be a crucial consideration.
- The Alternative Investment Fund Managers Directive and other increased regulatory requirements mean additional considerations for managers of real estate funds, primarily in terms of risk management, disclosure and reporting.
- Do any proposed restrictions breach the Chapter I prohibition of the Competition Act 1998? The sorts of agreements which cause concern in this context include restrictive covenants imposed on key land parcels after sale between competitors, and user covenants and exclusivity agreements in leases.
- When investing in an underlying business, there will be additional business-specific issues to consider. Some of these are regulatory, such as the Care Quality Commission regime in respect of care homes, while others are business-specific such as the importance of franchise hotels remaining brand-compliant.

## CASE STUDIES TWO RECENT PROJECTS BY PATRON CAPITAL, AN INSTITUTIONAL INVESTOR FOCUSED ON PROPERTY-BACKED INVESTMENTS

### Acquisition, growth and sale of Motor Fuels Group ("MFG")

Patron Capital took an 87% stake in MFG in December 2011 for an initial investment of £28.3m, then sold it to Clayton, Dubilier & Rice in June 2015 for £500m.

Via a series of strategic acquisitions, Patron expanded the business from 48 sites to 373 sites and added a dealer network of more than 200 sites, making it the UK's second largest independent petrol and convenience retailer. The company generated more than £1bn of sales in 2014, and was ranked ninth in the



Sunday Times Profit Track 100 list in 2015.

Patron restructured MFG into a more real-estate style business, with an efficient central operating platform that enabled it to integrate past and future acquisitions.

MFG operates under the BP, Shell, Texaco and Jet brands and has retail partnerships with Costcutter and Costa Coffee.

This highlights Patron's strategy of:

- investing in a niche, consolidating sector with significant opportunities;
- backing a strong management team to scale up a business from a small platform to a major operation;
- focusing on the strong real estate play; and
- positioning the business for the next stage of its growth.

### Development and sale of Gracewell Healthcare

Patron founded the Gracewell business in 2010, having recognised the potential of the care home sector in general and the purpose-built, luxury private-pay subsector in particular. Gracewell has received



awards for both care and asset quality.

Patron sold Gracewell in 2014 for £153m. The portfolio of 11 premium-quality seniors housing communities (comprising 767 units) was acquired by Health Care REIT and the management company was bought by Sunrise Senior Living.

Patron has an ongoing partnership with Health Care REIT, Sunrise Senior Living and Gracewell, and has established a new care home development arm, Hamberley Developments, which is currently constructing nine new care homes.