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# Opportunities in challenging markets: Sale-and-Leaseback, Build-to-Suit and other new Real Estate deal structures in the UAE

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Against a backdrop of lower oil prices and reduced government spending, real estate markets across the UAE have softened in recent times, resulting in tightened liquidity and contracted asset values. However, challenging market conditions have also generated exciting deal opportunities for investors and developers with an appetite for risk and ready access to capital. For instance, we have seen a number of below-market-value acquisitions of distressed real estate in the last few months. What is particularly interesting in the current market, though, is that these deals are increasingly being implemented using sophisticated, technical transaction structures that are relatively new to the UAE.

In this briefing, we look at two of these structures in more detail – namely, "sale-and-leaseback" and "build-to-suit". We also touch on a third structure, "loan-to-own", which we believe may arrive in the market in due course.

## Sale-and-leaseback

### What is a sale-and-leaseback transaction?

In its purest form, a sale-and-leaseback involves a party selling a property to a buyer, with the buyer simultaneously leasing the property back to the seller on a long-term basis (typically 20 to 30 years). Sale-and-leaseback structures are common globally, particularly in markets such as the UK and the United States. However, they have only come to the fore in the UAE over the last couple of years. The first notable deals in the market occurred in late 2013, with GEMS Education selling two of its academies in Dubai (one to Emirates REIT, the other to Pinebridge) and simultaneously leasing them back on a long-term basis.

These structures are most relevant in the context of owner-occupied properties of relatively high capital value. As such, they are most commonly used in connection with assets such as hospitals, hotels, shopping malls, supermarkets and (as mentioned above) schools. However, they are increasingly being used in the context of other types of assets, such as data centres and industrial and warehousing facilities.

The nature of a sale-and-leaseback structure, where the party providing the finance also takes ownership of the asset, uniquely meets the requirements of Islamic finance as well as being a conventional financial tool.

## Why are they used?

From the seller's perspective, a sale-and-leaseback is essentially an alternative method of financing achieved by unlocking capital (in the form of real estate assets) from its balance sheet. The proceeds realised from the sale of the property can be reinvested in the business, used to expand or (of particular relevance in the context of a distressed sale) used to pay off debt. Going forwards, the seller is able to carry on running its business at the property pursuant to its new leasehold interest, but without having to worry about the usual risks, burdens and obligations associated with property ownership (except to the extent that these have been placed on the seller as tenant under the leaseback arrangements).

From the buyer's perspective, a sale-and-leaseback involving a long lease to a tenant with a strong covenant is an attractive proposition. The lease delivers a long-term, stable and predictable income return somewhat akin to a bond in nature, but with the added benefit of fixed increases via periodic rent reviews. In addition, a sale-and-leaseback is also a capital play, given that the buyer will benefit from any increases in the capital value of the underlying property. Furthermore, in many countries there is (given their attractiveness to investors) a secondary market for sale-and-leaseback structures, meaning they are comparatively liquid as an asset-class.

As noted previously, the capital appreciation (the risk and reward of owning the asset) together with the generation of a return through the collection of rent, also makes the structure appealing to providers of Islamic finance.

## Why are they prominent in the current market?

Whilst sale-and-leaseback structures have been used in the UAE for the last couple of years, they have become increasingly relevant of late. The economic downturn has created an environment where many owner-occupiers have been increasingly unable to partake in conventional funding sources (such as bank lending and IPOs) and have instead been forced to seek out non-conventional sources of funding, such as sale-and-leaseback. This has created an opportunity for investors to enter the sale-and-leaseback market, at a time when (given prevailing economic conditions) they are generally able to acquire assets comparatively cheaply, and rent them back at a premium to market value.

## How are sale-and-leaseback transactions typically structured in the UAE?

Whilst a sale-and-leaseback transaction is conceptually very simple, on a practical level there are many different ways in which one can be structured. For instance:

- The buyer may be purchasing the asset directly or, alternatively, the buyer may be purchasing a corporate vehicle that owns the property.
- In many cases, the buyer will be acquiring freehold title to the asset. However, this will not always be the case. In the UAE context, the buyer may instead be acquiring a musataha, usufruct, leasehold or, potentially, strata right from the seller. For example, Emirates REIT holds its GEMS academy in Al Barsha South pursuant to a long lease (expiring 2056). Foreign ownership restrictions may be relevant in this context. For instance, the buyer may not be legally entitled to hold freehold title, in which case the parties may agree that the seller will retain the freehold interest but grant a "virtual freehold" lease (or other interest) to the buyer, with the buyer then granting a shorter term occupational interest back to the seller.
- Similarly, in many cases, the buyer will be granting a lease back to the seller. However, again, this will not always be the case, and in the UAE context the buyer may instead be granting a musataha, usufruct or, potentially, strata interest back to the seller. A key limitation in this regard is that the buyer cannot grant an interest superior to its own. For instance, if the buyer has only a lease of the property itself, then it cannot grant a superior interest (i.e. freehold, musataha, usufruct or strata) to the seller, and its only option will be to grant a sublease that is shorter in term than its own lease.
- The buyer may be leasing back the whole property to the seller. However, in the context of a large site, or a large building which is not fully-occupied by the seller, the buyer may alternatively choose to carve up the property and lease only part of it back to the seller.

# Build to Suit

## What is a build-to-suit transaction?

In its simplest form, a build-to-suit transaction involves a developer constructing a building for a designated occupier, to the occupier's specification. Upon practical completion, the building is handed over to the occupier, usually by way of a freehold transfer or the grant of a long lease. The model is common globally. However, whilst the structure has been used in the UAE for some time now, like sale-and-leaseback it has only really come to prominence in the last couple of years, in the shape of major deals such as HSBC's new US$250m build-to-suit headquarters in Dubai currently being developed by Gulf Resources.

Build-to-suit is relevant in any scenario where an occupier requires customised premises that may not be generally available on the open market in the required location. Historically, it was most often seen in the context of office and, to a lesser extent, warehousing and industrial premises. In the UAE, we are increasingly seeing it used in the context of hospitals, schools and staff accommodation.

## Why are they used?

From the occupier's perspective, a build-to-suit structure provides bespoke, customised space (that may not otherwise be available in the relevant location) without the occupier having to assume development or ownership risk or fund the development costs directly.

From the developer's perspective, a build-to-suit structure provides certainty. The occupier is contractually bound to acquire the relevant interest in the property upon practical completion at the pre-agreed price. This means that the developer has certainty of outcome before it commences the development works, and (unless it already owns the land) before it even acquires its interest in the land. Having an identified occupier contractually bound from the outset is significantly more attractive for most developers than speculative development, particularly in an uncertain market. Furthermore, built-to-suit premises can achieve higher returns for a developer, given that an occupier is more likely to pay a premium for space that has been specifically customised for it as opposed to generic space that may not fully satisfy its requirements.

## Why are they prominent in the current market?

Build-to-suit structures have been used in the UAE for some time. Historically, this was largely due to the lack of available Grade A office stock. However, the recent softening of real estate markets has (as with sale-and-leaseback) made build-to-suit increasingly relevant. The economic downturn has created an environment where many occupiers are unable or unwilling to raise finance to self-develop (and are equally reluctant to assume development and ownership risk). Build-to-suit is essentially an alternative way in which occupiers can fund new developments, by shifting the initial costs and risks onto the developer. This creates an opportunity for developers to step in and take a margin for arranging the funding and assuming these risks. Given the recent compression of asset prices, developers are able to acquire development land comparatively cheaply at present. In the current uncertain market, developers also have the benefit of certainty, in terms of having an occupier (and a price) contractually agreed before commencing development works, acquiring land or otherwise committing significant capital.

## How are build-to-suit transactions typically structured in the UAE?

Like a sale-and-leaseback arrangement, a build-to-suit transaction is conceptually very simple but, on a practical level, there are many different ways in which one can be structured. For instance:

- Most commonly, the developer is the owner of the land, which it holds during the development phase. The land may have been owned previously by the developer or it may have been acquired specifically for the purposes of the development in question. In this scenario, the building would typically be handed over to the occupier upon practical completion.
- The land in question could also be owned by a third-party who has entered into a JV or other arrangement with the developer. This structure is relatively common in the UAE. In the context of a JV, the landowner would typically contribute its land to the JV, with the developer contributing its expertise and potentially some equity. Rather than a JV, the arrangement could also be structured under a simple development contract, or under a musataha agreement (by which the third-party landowner retains freehold ownership

of the land, but grants the developer musataha rights allowing it to develop the land). In either case, the building would (as above) typically be handed over to the occupier upon practical completion.

- The land in question may also be owned by the occupier from the outset. This model is less common (particularly in the current market), but it is nonetheless still seen in the UAE. The occupier may already own the land, or it may have acquired it specifically for the purposes of the development. In this scenario, title is vested in the occupier from the outset, and thus there is no title transfer or grant on handover.
- Whilst the titleholder to the land during the development phase (whether this be the developer, the occupier, a third-party landowner, or a JV company) may hold freehold title to the land, this will not always be the case. In a UAE context, the developer could instead acquire an existing (or be granted a new) musataha, usufruct or leasehold interest over the land. Foreign ownership laws may limit the type of interest that the titleholder can hold.
- When (in the context of the first two structures discussed above) the completed building is handed over to the occupier upon practical completion, this may be by way of a freehold transfer to the occupier. Alternatively, the occupier may instead obtain musataha, usufruct, leasehold or strata rights. If the developer retains an interest in the completed building, it may hold this for income stream purposes (i.e. for the purpose of taking a rent from the occupier) or it may sell this to an investor. Again, foreign ownership laws may limit the types of interest that can be held by the various parties.

# Loan to Own

## What is loan-to-own?

This is where an investor acquires a non-performing loan secured against real property (at a discounted price reflecting the degree of impairment of the loan), with a view to enforcing the security and taking possession of the property. These transactions have come to the fore since the financial crisis of the last decade in markets such as the UK, Europe and the United States. However, for reasons discussed below, they have not yet featured in the UAE. The key benefit of loan-to-own is that it creates a secondary market in which mortgage lenders can dispose of distressed debt secured against real property (for instance, to ensure ongoing compliance with capital adequacy requirements), whilst providing opportunistic investors with an innovative method for acquiring real estate assets at a discount to market value.

## Why do we think it could arrive in the UAE?

Historically, loan-to-own has not been possible in the UAE, because the legal framework did not enable a mortgagee to foreclose on and take possession of a property, and its only enforcement option was to sell the property at public auction. This remains the case outside the Dubai International Financial Centre ("**DIFC**") and the Abu Dhabi Global Market ("**ADGM**"). However, inside the DIFC and the ADGM, a mortgagee has wide-ranging rights following mortgagor default, including the right to foreclose on and enter into possession of the property and receive the rents and profits from it. As such, these enforcement regimes open up the possibility of loan-to-own transactions in the UAE, albeit within the confines of the DIFC and ADGM (and provided of course that the relevant mortgage deed does not prevent the transfer of the security to a third party). As far as we are aware, no such transactions have been carried out in the UAE to date. However, as real estate markets and legal frameworks continue to mature in the UAE, we suspect that these structures may start to appear in time to come.

# Conclusion

The softening of real estate markets in the UAE has created an economic environment where sale-and-leaseback, built-to-suit and other "structured" real estate transactions have become more attractive and more prominent. However, in our view, it is also the increasing sophistication of investors, developers and other market participants as well as (inextricably linked to this) the increasing maturity and robustness of legal frameworks in the UAE, that is facilitating the growing use of such transaction structures.

What is clear is that these structures are opening up new ways of acquiring, investing in, developing and dealing with real estate assets in the UAE. Although these structures have increased in prominence during (and as a result of) the softening of real estate markets in the UAE, it is our view that they are here to stay, and will continue to be used as markets strengthen over time.

Finally, a cautionary note. Although these transaction structures are simple in concept, in practice they are complex and intricate, with a host of variances, subtleties and moving parts. There are many legal and commercial issues that will need to be addressed and worked through; for instance, foreign ownership laws may be relevant, transfer fees will be payable in the usual way and various third-party consents may be required. As the structures are relatively new to the region, they may be unfamiliar to interested parties such as superior titleholders, bank lenders and relevant authorities. As such, our advice is that these structures should be handled with care, and you should consult your legal and other advisers at the earliest opportunity if you intend to participate in them.

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