Property Views

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A NEWSLETTER FOR LENDERS AND PROFESSIONALS EXPLORING THE CHALLENGES AND OPPORTUNITIES FACING THE DISTRESSED REAL ESTATE SECTOR

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Welcome to the latest edition of Property Views.

The last edition commented on the changing economic and political landscape but it is safe to say the changes we have seen in the last 12 months have been unprecedented in recent times.

Between Brexit, stamp duty and business rate changes, there have been significant implications for both the commercial and residential real estate sectors.

After initial falls in the stock markets and the suspension of certain property funds, the UK economy has outperformed post-Brexit forecasts and remains robust. Moreover, the devaluation of sterling has also ensured that the UK has remained an attractive market for foreign investment. Nevertheless, in the immediate aftermath of the referendum result, and as a result of other market specific factors, we did see certain property values drop and some borrowers breach their loan to value (“LTV”) covenants.

For residential investors, the increase in Stamp Duty Land Tax (“SDLT”) from 2016 has led to a significant cooling of values and transactional volumes at the upper end of the London market, although this is yet to filter through into the lower end of the market and regional property prices. As a result, London is no longer leading the general price rises throughout the country and investors appear to be increasingly looking towards regional markets for returns. For example, recent reports suggest that Middle and Far Eastern buyers have doubled their investments in regional markets during 2016 and Manchester recorded the highest price rises in the last 12 months.

The general consensus within the property market is disappointment that the Autumn Statement didn’t address the discontent surrounding the proposed changes to Business rates. Business rates generated c£26 billion last year. According to Jones Lang Lasalle (“JLL”), rates on prime property in Shoreditch and Kings Cross are set to increase by 142% and 85% respectively. Other parts of the country are also set to be affected with estimates of a 70% increase in Reading and 55% in Milton Keynes. As inflation from the general increase in world commodity prices and the devaluation of sterling feeds through into high domestic prices and squeezes UK consumer spending, being c. 80% of the UK economy, it is anticipated that such cost increases will add to the pressures on an already challenged retail sector.

Therefore, all sectors are facing the challenge of the current uncertainty within the business environment and business rates rises. Moorfields has dealt with a large number of appointments across numerous sectors, further details are provided later on in this publication, which have enabled us to proactively advise on such matters.

Author: Lauren Wentworth, Manager
Moorfields Advisory Ltd

Key market trends

With the UK property market in turbulence following the referendum result we reflect on how the market has changed over the last 5 years.

Few would have thought that anything could shock the market like the demise of Lehman Brothers, but whilst Brexit has sent the market into turmoil could the financial consequences be as catastrophic.

In short the answer is probably no but there remains a great deal of uncertainty especially until deals are struck with European markets.

Here we explore how the sectors have performed over the last 5 years and our expectations for the market.

Retail

Our largest appointments in 2016 were over shopping centres.

Over the last 4 years Moorfields have seen an increase in Retail appointments especially over secondary out of town shopping centres.

Expectations

The future of retailers especially fashion will only become clearer once we see whether we can achieve an amicable exit from the EU.

Whilst global markets will become more accessible, the cost of purchasing goods internationally will inevitably become more expensive which over time will be passed on to consumers.

Bricks and mortar retailers will need to continue to be diverse to compete with online retailers.

Impact of rates -Nearly three quarters of small companies in London say business rates are the biggest consideration so the rates review carried out has been met with trepidation. Businesses are taxed on the basis of rent values which means London and the south east which has seen prices shoot up, retailers could face a 400% increase over five years, which will almost certainly result in more closures.

Residential

2016 saw a flurry of residential appointments only last seen in 2012

Much of this was due to distressed debt funds, who were responsible for a number of our formal appointments following the acquisition of NPL portfolios from traditional lenders.

Expectations

In the next two years we expect to see greater caution amongst buy to let investors with 3% stamp duty surcharge, reduced tax relief and tighter lending criteria.

With the government trying to support residential developers we expect to see reduced regulations but the market will remain challenged as the builders struggle with lack of migrant workers and increased commodity prices.

Agriculture

2014/2015 we saw a peak in agricultural appointments
Since then the market has stabilised but we continue to see the sector as critical

Expectations

With the Common Agricultural Policy subsidies no longer guaranteed and uncertainty remaining regarding the nature of our EU exit the future remains uncertain.

60% of UK produce is exported to the EU so a tense period remains whilst negotiations continue.

UK farmland especially land with additional income potential remains in high demand.

Commercial

Out of town commercial properties remained a large percentage of our appointments

Commercial appointments are now suffering from LTV breaches due to the drop in property prices. Commercial stock is continuing to attract a large amount of investor interest as more residential buy to let investors are turning their attention to commercial property opportunities.

Expectations

We expect to see reduced rental activity but with lack of new supply demand should remain steady which will also support regional office appointments.

Healthcare

In 2014 just under half our appointments were in the healthcare sector.

Healthcare appointments continue to be on the increase, 2016 saw the industry suffer its sixth consecutive year of increased care home insolvencies

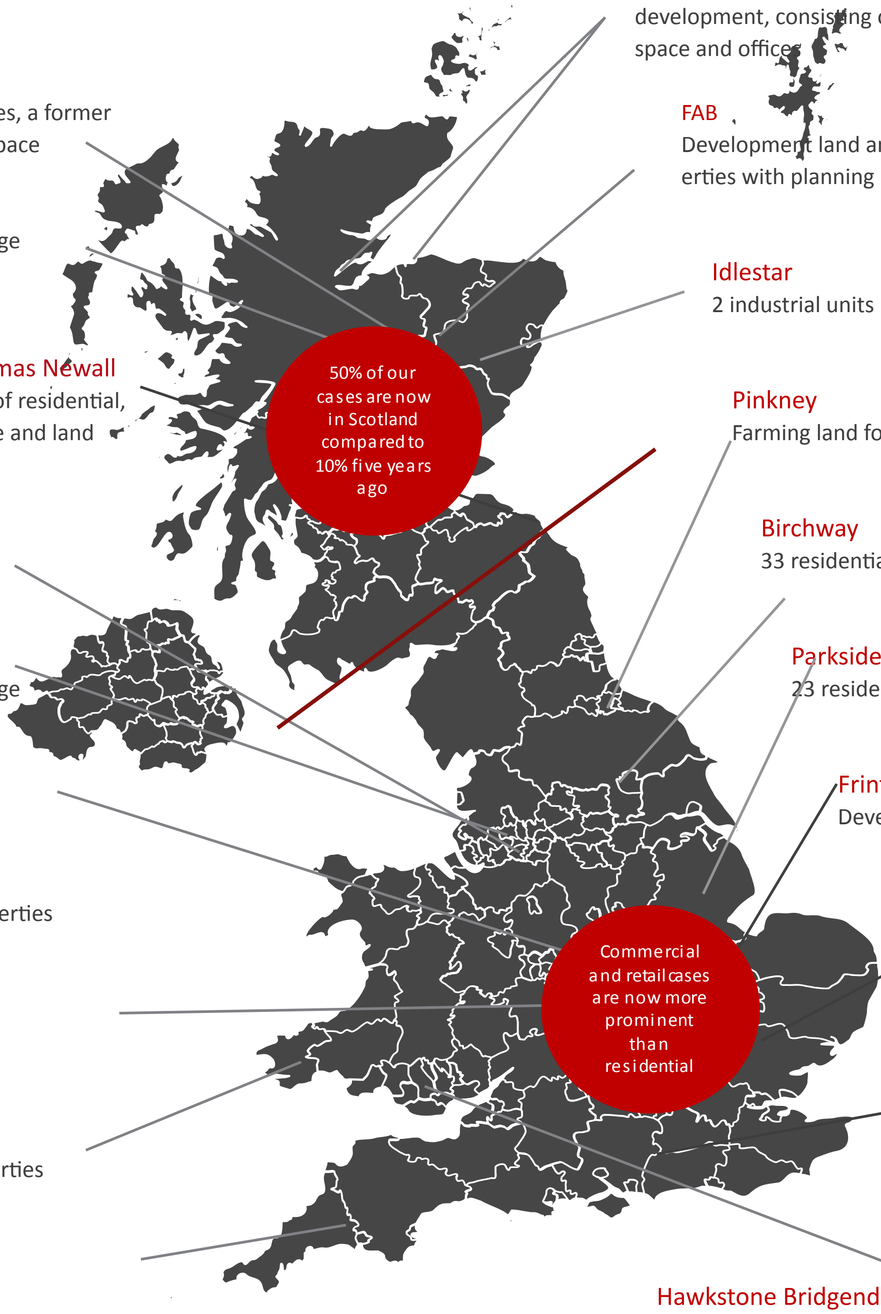
Expectations

Unfortunately the industry remains under pressure and is confronted by reduced margins as council budgets fail to cover increased operating costs.

In addition many are struggling to deal with the living wage increase.

Geographical Spread

Appointment locations over the last 5 years



Portfolio characteristics

- Appointments over portfolios of over 10 or more properties increased over the last 5 years
- Mixed portfolios appointments are more common this has shifted historically from being large residential portfolios
- Portfolio sizes are now typically over £10m where historically asset values of £1-5m were most common.
- 70% of the commercial or retail properties we see require asset management to increase occupancy prior to sale
- Build out properties feature heavily in our 2016/17 appointments

Landlord v Tenant

What impact will the new insolvency landscape have on the Real Estate sector particularly landlords and tenants.

The UK has prided itself on having one of the most efficient and robust insolvency regimes compared to its international counterparts but with laws remaining unchanged for nearly 30 years many have questioned if they are still fit for purpose. Consequently the birth of the "Insolvency Rules 2016" .....

So what are the changes:

New 2016 rules

- **Consolidation and modernisation of existing rules** – *ensuring the rules are easier to understand and avoid repetition*
- **Creditors Meetings** - *Physical creditors meetings will be removed unless requested by 10% of creditors in value or number*
- **Creditor consent** – *where insolvency practitioners have written to creditors and do not receive objection from 10% of creditors the proposals will be deemed approved.*
- **Electronic communication** – *correspondence with creditors can now include voting buttons and virtual meetings.*
- **Website usage** – *creditors can now be updated via the website*
- **Small Dividend payments** – *for £1000 are now deemed proved without the creditor needing to complete a proof of debt*

In addition the government is currently consulting on 4 new proposals for a new corporate insolvency framework.

- *A 3 month moratorium to give companies an opportunity to consider the best way forward whilst remaining protected from creditors*
- *Essential contract protection - binding essential creditors to continue to supply essential services during the restructuring period*
- *Cram down mechanism - binding creditors by a majority vote*
- *The development of rescue finance, allowing new finance agreements to take priority over existing creditors*

Perhaps one of the biggest challenges

Many landlords and insolvency practitioners have been vocal in their desire for the insolvency rules to change, especially following the ruling of Jervis and others v Pillar Denton Ltd and others (2014) arising out of the demise of GAME. The case addressed the payment of rent by insolvent tenants during administration, and ruled that insolvent tenants would be relieved of the unnecessary burden of paying an entire quarter's rent and instead be liable for rent on a daily basis during the period of administration. Effectively overturning the earlier case Goldacre (Offices) Ltd v Nortel Networks Uk Ltd (in administration) 2009 and reverting back to the original ruling in 1990 of AIB Capital Markets plc and another v Atlantic Computer Systems plc and others.

Unfortunately, the new rules have not addressed this, consequently whilst landlords on a case by case basis may be better off, the broader picture may be that more leasehold properties will be vacated on day one of an administration, leaving the landlords high and dry for an extended period. There may also be an increase in the number of liquidations offering insolvent companies the opportunity to disclaim leases, thereby forcing the burden of the non-domestic rates liability and other void property costs back on to the landlords.

So what is going to change...

The 2016 rules will see the removal of physical creditors meetings, for landlords this will make it far more difficult to hold insolvent tenants liable for unpaid rents and wrongful trading. Going forward landlords will need to hold at least a 10% value of creditor claims to request a creditors meeting.

Now let's consider those proposals

The Department for Business, Innovation and Skills last year suggested a number of amendments to the corporate insolvency framework, aimed at creating a realistic rescue culture giving businesses the best possible chance to restructure their business whilst still protecting their creditors.

Whilst the proposals are still under an extended consultation period while the Government assesses feedback they are expected to reach an outcome shortly.

The proposal most likely to affect Landlords is the introduction of a moratorium lasting 3 months , during this period companies can consider their rescue options whilst being protected from creditors. Both R3 and the British Property Federation have raised their concerns at the length of time suggested and in turn suggested a reduced period of 21 days.

Whatever the outcome any such moratorium will leave many landlords with the continued unanswered question of rent payments. At the moment it remains unknown that if the courts agree a moratorium whether they would clarify the rent position. Consequently, landlords will be left wondering what will happen to rent during the moratorium period? if it is expected that rents are paid which funds will these be paid from? What happens if the tenant has no money to pay rent following the moratorium period? At least as current case law stands, tenants will be liable for rent for the period the property was occupied. Unfortunately, this could mean the proposals have the complete reverse affect for landlords and instead of creating a rescue culture it could create a loophole for tenants to abuse the framework to not pay rents and leave landlords unable to take further action until after the moratorium.

The latest casualties to hit the press, *99p store* and *Store Twenty One,* only further highlight just how difficult the problem is for landlords. Poundlands 99p stores fell into administration last month closing 60 of its stores and Store twenty one is in discussions with its lenders after being unable to meet quarterly rent payments, the store entered a CVA last year persuading a number of its landlords to accept a 25% reduction in rent to continue to trade.

The second proposal is to help businesses to continue to trade during the restructuring period by maintaining essential contracts, we currently already apply this law in the UK to utilities but it is unsure how far this will now stretch and whether landlords will be included in this? There may be restrictions on a landlord's ability to forfeit leases or to seek a surrender unless tenants agree during restructure.

"instead of creating a rescue culture are we creating a loophole for tenants to abuse the framework and leave landlords unable to take further action until after the moratorium"

The third proposal is known as the cram down mechanism binding secured and unsecured creditors to mutual agreement. This mechanism will work against the interests of creditors including landlords in situations where there are insufficient assets to pay secured creditors. Landlords may be forced to accept unrealistic ongoing terms or be faced with the return of an empty property.

Proposal four is the development of rescue finance, allowing any new finance arranged during the rescue period to take priority over security granted to existing creditors this poses a real threat to landlords and has never before been seen in UK insolvency.

In summary ....

The proposals present some very real concerns for commercial landlords and the payment of rent in an insolvency estate and where they rank in the creditor line up. We advise that landlords keep abreast of the changes while we wait for the Insolvency Service to publish their revised proposals after taking into account the views of R3 and the British Property Federation.

Landmark Property Sale

Commercial Property in the heart of Liverpool

EXCHANGE FLAGS, LIVERPOOL BUSINESS DISTRICT

SOLD: £42 MILLION

The prestigious Exchange Flags building, in the heart of Liverpool's business district has been sold for £42 million by Moorfields.

The building consisted of 350,000 sq ft of office space, restaurants and was where the Battle of Atlantic, one of the pivotal campaigns of WW2, was planned and directed from the Western Approaches Command Headquarters located in the building. There is now a museum in the basement to commemorate this victory.

Simon Thomas, Partner at Moorfields said " This was far from a straight-forward sale. On appointment tenancy levels were low and the managing agents had done little to attract new tenants. We instructed builders to carry out refurbishment work to the interiors of the building to create flexible office suites to make lettings more suitable. Following this we carried out some extensive marketing with local agents, and updated the website to maximise interest.

Furthermore we instructed an advertising company to utilise outdoor space to hold film screenings, plays and pop up restaurants to increase exposure and brand awareness.

Simon continues " The building also had a pre-existing overage agreement that could have potentially affected the sale. Working with our lawyers we re-negotiated with the tenant to ensure a smooth sale."

Arron Kendall, Partner at Moorfields said " We are delighted to have achieved the sale of this property, it was a complex building with many different revenue streams. It is great to see the building continue to showcase its history whilst maintaining its commercial tenants."

> "We instructed builders to carry out refurbishment work to the interiors of the building to create flexible office suites to make lettings more suitable"

Healthcare Market Overview

The estimated value of the UK Elderly Care market is £15.9bn, of which the private sector accounts for £12.1bn. The percentage of the UK population aged over 65 is forecast to increase by 5.8% by 2031 with the greatest growth in those aged over 85.

The prevailing theme in conversations our National Healthcare Team is having with good care providers, is that whilst still challenging, the operational environment is beginning to feel less oppressive than it was. Most operators have been through a period of sustained operational challenge and have been required to review every aspect of their businesses, in many cases making strategic decisions to improve their performance. Where companies have the management talent to grow the business, the opportunities in the market are multiple if strategic benefit can be delivered through M&A and/or the lessons learned about optimising operational performance can be adapted for the target business.

We see significant opportunity and activity in the operational Care market and have worked with buyers to identify and source the best financing options via traditional senior debt routes, new non-traditional lenders, or from innovative healthcare real estate investors who can diligence the operational risk and deploy capital to support the operators expand their business.

Multiple operational businesses changed hands towards the end of 2016; Lifestyle, Exemplar, Acer, Helen McArdle and Silk Healthcare are just a handful of examples, indicating that appetite amongst buyers remained healthy. Transactional activity in the Healthcare sector in Q1 2017 has been more varied and whilst a number of trade buyers such as Elysium have continued the spending spree, long income has once again been to the fore.

The nature of investors appears to have changed, with UK trade buyers showing to be the dominant purchasing group for care homes. This suggests that good operators are managing in the face of sector headwinds and that the sector is more sustainable than some of the negative headlines would infer.

Corporate activity in FY16 was very strong across the market, particularly in the specialist care sector where over £2.2bn transactions closed. Earnings multiples suggest that platform and bolt-on acquisitions remain keenly priced.

Whilst healthcare real estate investment volumes were down markedly in FY16 relative to the period FY13-15, current investment activity indicates an uptick in volumes over 2017. CBRE estimate that transactions in the order of £850–£900m closed in 2016, with current investment volumes indicating half year 2017 will top £700m.

In spite of the 4 largest providers operating 1,150 homes and 68,000 beds between them (c.14% market total), the UK Elderly Care market remains fragmented with the largest 25 operators providing around 29% of total registered elderly care beds.

However, the pressures facing the Sector remain and revolve around lack of funding, compressed fee rates and rising costs. Many Local Authorities are not paying the true cost of care and their fees have gone backwards in real terms. Since 2009, spending on adult services has fallen in real terms by 8% against a backdrop of rising costs.

At the same time, The National Living Wage alone could raise base salaries up to 10% in many locations in one year. This combination is not financially sustainable and is affecting certain parts of the country much more than others. However, care homes are property intensive businesses which require continual investment and improvement, without which trade will suffer and the squeeze on margins is affecting those businesses not able to afford to invest.

The sector has seen increasing inflow of capital with activity at portfolio level and in new developments in particular, in part buoyed by the increased funding from the council tax precept and Funded Nursing Care which has boosted income streams. However, it is only papering the cracks as the underfunding remains and in many parts of the country, it costs less to stay in a hotel than to provide 24 hour care in a home.

The number of homes closing is accelerating and in 2016 there were c. 100 new homes built but over 160 closures, albeit these averaged under 20 beds in size. However, with the elderly population increasing, the pace of new development against care home closures is not enough.

There is a widening polarisation between modern homes in affluent areas and those reliant on funded places. For "best in class" self-pay homes pricing is at an all time high but for the majority, buyer interest is more muted and selective. This offers opportunity to groups and private equity looking for operational platforms that can be improved and upgraded.

It is those areas most heavily reliant on Social Services funding that are most affected by low fee growth and increased wage cost. Until the funding shortfall is addressed and there is full recognition of the true cost of providing quality care, inevitably those who suffer most will be the vulnerable elderly.

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Moorfields Property Solutions

Our specialist property team is dedicated to supporting secured lenders in handling some of the complex issues arising in property insolvency. Unlike many other firms our property team dedicate 100% of their time to property assignments so are constantly up to date with the latest developments and market related issues.

Our expert knowledge and understanding of different types of property mean we can readily identify the most appropriate strategy.

Our focus is to offer a dedicated service with straight forward recommendations and realistic solutions to ensure we maximise the financial outcome for our clients and business stakeholders.

Want to find out more?

To find out more about Moorfields' restructuring and insolvency services contact: Simon Thomas on 0207 186 1140.

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