CORPORATE BRIEFING

Public M&A in the real estate sector: issues and trends

In the last three years, there have been 15 takeovers of UK listed real estate companies, with eight announced or completed in 2024 alone. Many more took place in the preceding years. In the majority of these transactions, the bidder has been another listed company (*see box "UK Listing Rules"*). However, there have also been a number of bids by private equity buyers.

These transactions are governed by the Takeover Code (the Code) and follow the same process as other UK takeovers (*see feature article "M&A processes: getting the deal over the line", www.practicallaw.com/w-042-6795*). However, a number of specific issues arise on public bids for real estate companies.

UK Listing Rules

Many of the recent takeovers in the UK real estate sector have involved a UK listed company bidding for another listed company. These bidders will have to consider the UK Listing Rules (UKLR) (*see feature article "New UK Listing Rules: revitalising UK capital markets", www.practicallaw.com/w-044-1487*). The transaction will need to be classified and, if it is a reverse takeover, the bidder will be required to seek shareholder approval for the transaction.

A bidder that is listed under the Equity Shares Commercial Companies (ESCC) category and acquires another company listed in the same category will not generally be required to cancel its listing and seek readmission. Where a company listed under the ESCC category acquires a target company that has shares listed under a different listing category, it will need to demonstrate that the combined entity is eligible for the ESCC category in order to maintain its listing under that category.

If the bidder is a closed-ended investment fund listed under Chapter 11 of the UKLR, it will also need to consider whether the enlarged entity will be eligible for that listing category. If not, or if it otherwise wants to change its listing category, such as to the ESCC category, it would need to go through an eligibility process. A fund listed under Chapter 11 of the UKLR will also have to consider whether the transaction is within its investment policy and, if it is not, obtain shareholder approval.

Form of consideration

A review of public takeovers in the real estate sector in the last three years shows that most listed bidders have offered shares as part of the consideration. In many cases, the consideration has consisted entirely of shares in the bidder, with these transactions often presented as mergers.

However, some listed bidders have also offered an element of cash. This may take the form of a fixed combination of cash and shares that all of the target shareholders receive, or a cash alternative under which shareholders in the target company are able to make an election. This may be an election to receive a pre-determined proportion of their consideration in cash or a mix-and-match facility that allows the target shareholders more discretion to choose their mix of consideration, subject to a maximum aggregate amount of cash consideration that is available as part of the offer.

The commercial rationale for merger transactions of this type is usually the creation of a combined group of greater scale, with a larger balance sheet, a lower overall cost ratio, greater share liquidity and improved access to finance, including debt capital markets.

Where shares in the bidder are offered as part of the consideration, it will be necessary to agree the exchange ratio; that is, the number of shares in the bidder that selling shareholders will receive for each share in the target company. The calculation of the exchange ratio is commonly based on the relative net asset values per share of the companies. However, this may not be a straightforward accounting exercise; for example, the property portfolio of one or both parties may need to be revalued or the net asset value may need to be adjusted in order to arrive at the exchange ratio, which may require further negotiations between the bidder and the target company.

Take privates and other cash bids. Private equity firms seeking to take a listed real estate company private have invariably made cash bids. These bids are likely to be at a significant premium to the "undisturbed" share price; that is, the share price before any M&A discussions became public, and potentially also at a material premium to the target company's net asset value.

In a cash bid, the target company shareholders are offered an immediate cash exit at a price that may represent a premium to the level that the share price is reasonably likely to achieve in the foreseeable future. This may be attractive, particularly when the share price of the target company, or share prices across the sector or the market more generally, are depressed and represent a significant discount to net asset value.

Cash confirmation. Under the Code, a third party is required to confirm that the bidder has sufficient resources in place to satisfy full acceptance of the cash component of the offer. This confirmation is usually provided by the bidder's financial adviser. Therefore, any debt financing used to finance a cash bid must be on a certain funds basis, meaning that the bank(s) will be able to refuse to fund only in extremely limited circumstances.

Dividends. While not strictly part of the consideration, the treatment of dividends is generally an important part of the overall financial package relating to a public bid for a real estate company, given that listed property companies usually pay quarterly dividends and are valued by investors for the regular income that they generate.

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It is common to agree that the target company and, if it is a listed company offering its shares to target shareholders, the bidder, will continue to pay quarterly dividends in line with past practice. However, the parties will need to take into account the proximity of the companies' respective dividend dates and when their dividend payment dates fall relative to completion. On a merger, it is usual to specify when the bidder will pay the first dividend in which the target company shareholders will participate, assuming that the transaction completes in line with the anticipated timetable.

Share issuance authorities

If a listed bidder is offering shares as part of the consideration and the number of shares to be issued exceeds the share issuance authorities granted at the company's previous AGM, the shareholders will have to vote in favour of the necessary resolutions at a general meeting.

Due diligence

The due diligence undertaken on public takeovers is typically not as extensive as that carried out on private M&A transactions or when buying a property asset. Under the Code, any information provided to one bidder must also be provided to a competing bidder, even if that bidder is less welcome. This means that a target company may be reluctant to provide extensive due diligence information. However, there has been a trend in recent years for more extensive due diligence to be undertaken on some public takeover bids. In some cases, where there is a high degree of co-operation from the target company in relation to the bid, detailed due diligence can be carried out, similar to that seen on private deals.

A bidder may also take comfort from the fact that assets within the target company's portfolio are likely to have been subject to thorough due diligence when they were acquired or financed, and reports on title or other due diligence information from these historical transactions may be provided to the bidder as part of the due diligence process.

Due diligence will also involve a review of whether there are any competition law issues that could merit proactive engagement with the Competition and Markets Authority (*see feature article "UK merger control: what's in store for 2024?", www.practicallaw.com/w-042-2435*). The National Security and Investment Act 2021 may also be relevant where the target company, or potentially the bidder if the transaction is a merger, owns assets that have a link to sectors with a national security dimension (*see feature articles "National Security and Investment Act 2021: taming the M&A dragon", www.practicallaw.com/w-032-2847 and "Foreign direct investment: national screening regimes proliferate", www.practicallaw.com/w-040-3591*). Assets that are leased to any part of the government could fall into this category, as could other assets such as data centres.

Existing debt facilities

A bidder will need to understand any change of control provisions in the target company's debt facilities. A bidder will often want these facilities to remain in place after completion, in which case it will need to establish whether any lender consents are required. Lender consents can be sought before a firm offer announcement is issued under Rule 2.7 of the Code (Rule 2.7), although this is complicated by the so-called "rule of six" under which a bidder can generally only speak to a maximum number of six parties outside of its advisory team before it makes an announcement.

If lender consents are to be sought after the bid is announced, the bidder will have to prepare for the possibility of these not being obtained. For example, the bidder may negotiate a backstop facility that can be drawn down as required to finance any of the target company's debt facilities that are required to be repaid in connection with the takeover.

In addition, some property companies have negotiated long-term debt at a lower interest rate than is currently available or is likely to be available again in the foreseeable future. A change of control that occurs as a result of a successful takeover may trigger the repayment of this debt, which would directly affect the earnings of the target company and be an important financial consideration for the bidder.

Offer letter

On recommended bids, there will often be some negotiation of the bidder's indicative offer letter. As well as potentially negotiating the offer price, other matters, such as requirements in relation to the due diligence process, may also be addressed and the letter may set out pre-conditions to making the offer.

Non-disclosure agreement

Early in the process, the parties will negotiate a non-disclosure agreement (NDA). On a merger transaction, this is usually mutual. However, NDAs tend to extend beyond mere confidentiality obligations and now also typically include a number of other provisions, including:

- A standstill agreement under which the bidder agrees not to acquire shares in, or make a hostile bid for, the target company except in certain specified circumstances, such as a competing bidder announcing a firm offer for the target company.

- Undertakings not to solicit the other party's employees and to deal only with specified individuals at the target company in relation to the bid.

The NDA will be displayed on the websites of the bidder and the target company after the bid is announced.

Rule 2.7 announcement

The offer will be launched by the release of an announcement of a firm intention to make an offer, known as a Rule 2.7 announcement. This announcement effectively commits the bidder to make its bid.

The Rule 2.7 announcement will contain a number of conditions. Certain conditions may be invoked without the consent of the Takeover Panel (the Panel); for example, the acceptance condition and conditions relating to legal requirements, such as required shareholder approvals or the admission of consideration shares to listing. However, the

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Panel's consent is required to invoke other conditions and will be granted only when the condition is of "material significance to the offeror in the context of the offer". The Panel interprets this as an extremely high threshold.

On a merger, the Rule 2.7 announcement will usually include extensive information on synergies and cost savings. If these quantify the financial benefits, and therefore take the form of a "quantified financial benefits statement", this must be reported on by accountants to the effect that the statement has been properly compiled and by a financial adviser stating that it has been prepared with due care and consideration.

Public documents

If the transaction is being implemented by way of a scheme of arrangement, the scheme document is usually required to be published within 28 days of the Rule 2.7 announcement (*see box "Transaction structure"*). Similarly, if the transaction takes the form of an offer, the offer document is required to be published within the same period. If the bidder is required to publish a prospectus in connection with the transaction, this is normally published at the same time.

To facilitate this, work on the prospectus begins early in the process and the parties often aim to submit the prospectus to the Financial Conduct Authority for review so that the first set of comments is received before the Rule 2.7 announcement is published. This is to ensure that those comments do not reveal any material issues and to provide some comfort that it will be possible to finalise the prospectus by the end of the 28-day period following the Rule 2.7 announcement within which the scheme or offer document is required to be published, so the documents can be published at the same time.

Valuation reports

Rule 29 of the Code requires parties to an offer to publish a valuation report in certain circumstances. It is common on takeovers of real estate companies for the Rule 2.7 announcement and the scheme document to refer to the net asset value of the target company, and of the bidder in the case of a merger, in order to refer to any premium that the bid price represents to net asset value and to explain the merger ratio, if applicable. In these circumstances, the Rule 2.7 announcement and the scheme document will usually need to contain valuation reports on the relevant party's property assets.

The reports must be prepared by an independent valuer in accordance with the RICS (Royal Institution of Chartered Surveyors) valuation standards or other appropriate professional standards approved by the Panel. It is customary for the valuation reports to be dated the same date as the announcement or document in which they appear and, if this is not the case, the valuer will have to confirm that an updated valuation would not be materially different. Carrying out the valuation exercise before the takeover has been announced can give rise to practical difficulties, such as physically inspecting properties without causing unwanted speculation.

External investment managers

Some listed real estate companies are structured as listed funds and have an external investment manager. This creates an additional set of potential issues. The external manager may have a fixed-term contract or a rolling contract with a long notice period, which may be expensive to terminate. This expense will have to be factored into the financial evaluation of the transaction and weighed against future cost savings. In the case of a merger, there may also be a negotiation regarding how this termination cost affects the merger ratio; that is, which party's shareholders effectively bear that cost.

The parties will also have to consider the future management arrangements for the business and related employment law issues. Employees of the investment manager who spend the majority of their time working on the business of the target company will transfer to the bidder under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (*SI 2006/246*). In addition, the bidder will want to ensure the continuity of operations and will be mindful that the staff of the target company's investment manager will have a good understanding of the company's assets and relationships with its tenants.

It is therefore common for many, or even all, of the investment manager's employees who service the target company to be retained after completion. The precise arrangements will have to be considered depending on the specific circumstances and there have been cases where the investment manager has been acquired as part of the wider transaction.

Transaction structure

A scheme of arrangement is now the default structure for implementing UK takeovers and, of the completed UK takeovers in the real estate sector in the last three years, only one was implemented as a contractual offer.

Schemes are perceived to have a number of advantages over contractual offers, including a quicker overall timeline for the bidder to acquire 100% of the shares in the target company and a lower voting or acceptance threshold to achieve that outcome. For a scheme to become effective, it must be approved by target shareholders that represent a majority in number and at least 75% in value of shareholders voting on the scheme. This contrasts with a contractual offer, which must be accepted by the holders of 90% of the shares to which the offer relates in order for the statutory squeeze-out rules to be triggered.

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