The Swedish real estate market: for investors, 2010/2011 may offer a ‘Swedish smorgasbord’ of real estate opportunities

by Jesper Prytz and Tomas Johansson, Mannheimer Swartling

Sweden, being an export driven economy, has performed surprisingly well during the global financial crisis. According to the Swedish National Institute of Economic Research, Swedish exports are up 10% for 2010. Together with an increase in household consumption and business investment, this will help Swedish GDP to rise by 4.3% in 2010 and, according to forecasts, by an additional 3.4% in 2011. Also, the Swedish real estate market has benefited from historically low interest rates and as a result of the above, investors seem to sense opportunities again.

During 2010, yield pressure and a positive outlook for the Swedish economy has led to an increase in market activity. Mostly domestic, but also foreign investors have ‘restarted’ the Swedish real estate transaction market. This market has long been considered transparent and liquid, but is this still true? To some extent, the use of structured deals has made the market less transparent.

Below we comment on the legal aspects of some investment methods currently being used.

Acquisition of a completed building (asset and share transfer)

Investments in completed buildings (especially single tenant and fully let premises) have remained popular also during the economic downturn. In Sweden, most commercial property has been dropped down into a special purpose vehicle (SPV). If done correctly, the SPV has no employees and has only conducted business in relation to owning and operating the property. The need for a financial and legal review of the company before a transaction is sometimes mitigated by extensive warranties from the seller but at least a minimum level of comfort should be obtained through a due diligence review. Even though acquisitions of property owning companies normally are pretty straightforward, a recurring negotiation point is the valuation of deferred taxes in the company (most commonly relating to differences in tax depreciation and book value depreciation). Since the purchase price formula often is defined as: agreed property value – book value of the property + equity (where equity is the net assets of the company), it is not necessarily so that deferred taxes are automatically reflected in the purchase price calculation. The amount deducted from the purchase price due to deferred taxes varies and will have to be negotiated on a case by case basis.

The obvious advantage of an asset deal is that the property is acquired without any corporate history, which would be the case in a share deal. However, direct acquisition of a property can be disadvantageous. First, a direct transfer will trigger stamp duty, which for commercial transactions is currently 3% of the purchase price, but will increase to 4.25% in January 2011. Second, certain provisions in the Land Code relating to defects in the sold property may become applicable unless waived by the parties and certain mandatory provisions regarding the form of the transfer deed (which in practice is not that cumbersome) will need to be observed. Thirdly, an owner of real estate which has been acquired after December 31, 1998 will automatically undertake a secondary responsibility for environmental contamination on the property, provided that the polluter cannot be held liable.

Acquisition of turn-key ready buildings under construction

Acquisition of turn-key ready buildings under construction from Swedish developers has been a frequently used method for foreign investors to enter the Swedish real estate market. From a legal perspective, such acquisitions are quite complex, especially as the parties normally negotiate the deal at an early stage of the property development process, while closing and final price calculation comes years later. Sometimes the building is not even under construction when the deal is signed. Establishing purchase price mechanisms that ensure the right incentives for the developer can prove a challenge, especially if (a) no or only a few lease agreements are signed when negotiating the sale; or (b) the construction agreement is not yet ready. Due to the lack of comprehensive Swedish mandatory building standards, it is sometimes in the ‘long-term property owner’s’ interest to agree on technical quality norms in relation to the building under construction (technical specifications). Rules regarding public
procurement should not be overlooked if the seller is developing a single-tenant-building for a public tenant. As from May 2, 2011 a new law for planning and building (Plan och Bygglagen) will be in force in Sweden. As far as is relevant for property investors, the timeline for a development project will then include the following milestones:
1. A detailed plan (DP) being decided by the municipality organ, creating ‘generic’ building rights.
2. The DP gaining legal force (if applicable, after appeal).
3. The developer applying for a building permit for the project based on the DP (i.e., taking the step from the generic building rights to a specified building right for the building in question).
4. The municipality granting the building permit.
5. The building permit gaining legal force (new rules).
6. Land proceedings (if applicable) regarding change of ownership/cadastral proceedings being executed by the cadastral authority and gaining legal force.
7. The final notice for the building permit being issued. As from this time, the premises may be used by the tenants (new rules).

The last milestone, the ‘final notice’, will onwards increase in importance for real estate transactions, since the new legal requirement will be that final notice must be obtained before the tenant can use the premises. In past practice, final notices have been issued months or even years after the tenants have taken possession of the premises. It is possible that the public authorities issuing final notice may not adjust its timeline for decision making to the timeline stated by the developer for the sale of the property. As most tenants don’t want to pay rent until they can use the premises, and as developers typically don’t want to take over the responsibility for the building until after the first rent is being paid, this will probably affect closing and conditions precedent for closing.

### Investment in a real estate fund

Real estate investment funds are not very common in Sweden. The few that exist mostly use limited liability companies as fund vehicles which invest in one or more properties. The fund vehicles are often governed by rigorous shareholders’ agreements and provisions in the articles of association.

### Club deals/syndicate

A limited number of investors acting jointly (club deal to acquire or syndicate) in acquiring real estate has been a rather popular investment method in Sweden, especially in relation to small and medium-size investments. Sometimes this structure is used for investors wanting to act as ‘silent partners’ and in such cases shareholders’ agreements between the investors are not always used. Instead, the investors sign an investment agreement with the management company, giving the management company a broad mandate to represent the investors, sometimes in relation to real estate acquisitions as well as disposals. A notable feature under Swedish company law in relation to such structure is that a proxy to be used at general meetings is valid only for one year at a time, which is easily overlooked by foreign investors/management companies.

### Investment into a property joint venture vehicle

Two parties investing jointly in real estate – a property joint venture vehicle (JV) – has been a commonly used method for investments in Sweden. Legal aspects of investing in property JVs in Sweden vary depending on if one of the parties is a public body. Private-public property JVs are significantly more complex from a legal perspective than other forms of JVs. Public bodies are subject to a number of legal limitations as regards the scope of and methods for acting together with commercial parties in property development.

Risk allocation based on the JV parties’ respective roles in the functioning of the JV is fundamental. However, it should be kept in mind that the right to demand specific performance by a party in breach of a commercial contract is rather limited under Swedish law.

Property JVs are often used in relation to development projects, which adds to the complexity. Under Swedish law, building rights are created through the detailed planning, which is controlled by the municipalities. If a municipality decides against a certain project (even for political reasons), there is little the developer can do in the short term to make the land sufficiently planned for development. The provisions in the JV agreement dealing with early termination should therefore also address this situation.

### Conclusions

Given the positive outlook for the Swedish economy there is an increase in the real estate transaction market, which is expected to rise further during 2010-2011. Many of the traditional investment methods are still in use, but the trend of investors and developers sharing the risk in construction has led to an increased use of structured deals and JVs. Such transactions are more complex and demand a higher level of sophistication in the agreements regulating the co-investments.

The new rules implemented for planning and building are aimed to simplify the process of obtaining building permits and thus facilitate new construction. However, even if the rules are simpler there is still an
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element of political risk at the early stages of any
collection project. Such risk needs to be handled in
property JVs and in acquisition of turn-key ready
buildings under construction.

Since a large portion of commercial real estate in
Sweden has been dropped down into SPVs, the effect
of the increase of the stamp duty applicable from
2011 on real estate asset transfers may not be all that
significant. However, the new stamp duty level will
incentivise purchasers of real estate to acquire real
estate indirectly through share deals rather than direct
acquisitions.

Even if it can be argued that some structured deals
have made the Swedish commercial real estate market
less transparent, it remains one of the most liquid and
transparent markets in Europe. Helped by Sweden's
significant rise in GDP and overall positive economic
outlook it is likely that the real estate market activity
will increase further.

Authors:
Tomas Johansson
Partner, Real Estate
Mannheimer Swartling (Stockholm)
Norrlandsgatan 21
SE-111 87 Stockholm, Sweden
Tel: +46 (8) 5950 6175
Fax: +46 (8) 5950 6001
Email: toj@msa.se

Jesper Prytz
Partner, Head of Real Estate
Mannheimer Swartling (Goteborg)
Ostra Hamngatan 16
SE-403 14 Goteborg, Sweden
Tel: +46 (31) 355 1672
Fax: +46 (31) 355 1601
Email: jpr@msa.se
Web: www.mannheimerswartling.se