

# Sweden – time for projects

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**Due to the steady increase in yields on the property market over the last few years, and the recent increase in interest rates, the focus of the Swedish property market has turned from fully developed properties towards project development. Since the developers have strived towards making exits at a very early stage in these projects, the sales structures have become a lot more complex than in 'traditional' acquisitions. As a consequence demands on the due diligence process and the contract structure have changed.**

Like in other European countries the property market in Sweden has been booming over the last five years. We have found that the good future prospects and stability in Sweden, together with a large influx of capital and a willingness by the banks to provide highly leveraged financing, have been important driving factors for this development.

Due to the increase in yields for fully developed properties over the last few years, and the recent rise in interest rates, the risk involved in such acquisitions has increased. As a consequence, we have found that the focus of the market has turned towards project development. One clear trend is that different constellations, often between small local developers and international investors, establish joint ventures specifically for project development. Since such joint ventures typically have an interest in establishing an early project profit it is common for such ventures to make its exit at a very early stage.

We have found that the sales structures in these kinds of deals get a lot more complex than in 'traditional' acquisitions, mainly because there are so many unknown factors involved. The quality of the building is, for instance, typically not fixed in its entirety and there are no tenants which mean that neither the rental income nor the extent of the costs related to the leases are known. Such factors do have a substantial impact on the value of the property; therefore the price of the completed property needs to be linked to the outcome of these factors. This has to be regulated in the contract documents related to the acquisition.

Although the acquisitions are generally made via a purchase of the shares in a single purpose vehicle established specifically for the acquisition, we will not address this particular issue below. We will instead concentrate on the acquisition of the project or property in general.

## Principal ways for divestments of the projects

We have seen two principal ways for divestments of the projects; so-called 'forward funding' and 'forward purchase' divestments. In the case of forward funding the investor acquires the property early in the process and takes on the responsibility of financing the development. In a forward purchase a sale and purchase agreement is also entered into at an early stage although the investor is not responsible for the financing of the project and does not take the property into possession until the development is complete.

The choice between forward funding and forward purchase is mainly a commercial decision, and the choice is generally dependent *inter alia* on the availability and conditions of the external financing of the project. So far we have seen a lot more forward purchase than forward funding projects on the Swedish market.

In both forward funding and forward purchase projects the developer is responsible for the development and letting of the premises and typically gets paid in instalments upon reaching predefined milestones. A basic purchase price is often paid once the building is completed, while the developer may be entitled to an additional purchase price upon successful letting of vacant space. Although the basic purchase price may cover the developer's project costs, the real potential in the project is typically linked to successfully letting the space. The developer's right to let the premises often extends by a couple of years beyond completion. Such a right is often combined with a rental guarantee given by the developer.

It is common that the developer's right to enter into leases is restricted and that a lease may only be entered into by the developer on certain conditions. Deviations from these conditions will require the consent of the investor.

## Issues to consider

We have found that the sales structures in forward funding/forward purchase projects get a lot more complex than in acquisitions of fully developed properties. The reason for this is, as mentioned before, that there are so many unknown factors affecting the project and the value of the property at the time when the contracts are signed. A selection of such factors are listed and discussed below.

### **Establishment of rent as a basis for the purchase price**

The purchase price is often tied to the level of occupation the developer achieves and calculated as a multiple of the rent. This means that the investor has a need to ensure that any kind of 'over-rent' shall be disregarded. Such 'over-rents' may occur in, for instance, the following situations:

- Expensive tenant fit-outs financed by the landlord can result in a rent which exceed what can be considered to be a fair market rent. The risk for such 'over-rents' may occur not only in the event of luxurious fittings but also in the case of tenants with special needs such as banks.
- Substantial rental discounts during the first years of

the lease may result in that the end rent (i.e. the rent at the end of the lease period) exceeds what can be considered to be a fair market rent.

It is up to the parties to agree what impact any such factors should have on the purchase price, and also how the qualifying rent shall be determined. Should, for example, only tenant fit-outs up to a certain cost level be counted? If so, how should any excess be dealt with? Should the average rent over the duration of the lease be considered instead of the rent at a certain point in time, and should rental discounts of a certain size be allowed (without any impact on the qualifying rent level)?

### **Lease criteria**

An investor typically has an interest in getting tenants with good creditworthiness as well as long leases and leases with high square footage. With the value of the property being related to the future income of the property it is always subject to much discussion what impact a lease of a certain kind should have on the purchase price.

One question is what kind of tenants should be permitted, both from a financial point of view and a business point of view? It is often quite difficult to

establish a level that both parties can accept with regard to creditworthiness and different ratings are often used as guidelines. However, such ratings are often based on the latest audited annual account and such information may not be up-to-date. The investor may also have an interest in limiting the leases to businesses of a certain kind, and sometimes also to completely exclude potentially dubious businesses.

Other issues which have significant impact on the value of the project are the length and size of the leases. As stated above, the investor typically wants both long leases and leases covering a high percentage of the building. However, it should be kept in mind that more areas may be regarded as 'lettable' in a large lease than in a smaller one. Such areas may include stairs and other areas which are not possible to lease in a multi-tenant building.

### **The quality of the project and how to deal with the development risk**

Due to the fact that the building is not built at the time of the sale the investor needs to secure the quality of the project in the contract documentation. This makes the construction agreement and project management regulations important documents along with the sale and purchase agreement. This also means that the person carrying out the technical due diligence has a significant role.

To secure the quality of the building the parties must attempt to foresee any risks during the construction. The Swedish system for handling risks in a development project is well established and the regulations for securing the quality are strict. However, to be able to define the risks it is essential to know how the system works under various conditions.

### **Standard form of contract**

Construction contracts are not subject to any specific legislation in Sweden. On the contrary, this is an area where the parties have considerable freedom to regulate their relationship as they think fit. This has resulted in the wide use of standard forms of contract. One example is the series of forms for construction contracts published by a special task force which includes representatives from the various participants in the Swedish construction market. These standard forms of contract are so widely used in Sweden that it is of little practical interest to discuss the legal rights and obligations of the parties in the absence of such a standard form of contract.

The standard form of contract is not adapted to cover all specific issues arising in a forward funding or forward purchase project, but the rules provide a good starting point. It is therefore of great importance that the necessary changes are made to the contracts at an early stage in order to adapt them to this type of acquisition.

### **The definition of and changes to the project**

The contract works defined in the construction agreement are rarely, in any project, the same as the final product. This is particularly the case in so-called turn-key contracts, where the project is not specified in detail but rather by functions. In such projects the developer has the responsibility to find the final technical solutions in order to achieve the required function. These kinds of construction agreements are, in our experience, the most common ones in forward funding and forward purchase projects.

In all larger construction projects there will be changes made to the technical solutions given and technical solutions often need to be changed due to unforeseen circumstances. The contract documentation needs to contain models both to handle additional orders related to the construction agreement and specify what kind of changes can be made by the developer without the approval of the investor. In this situation, the investor's need for control over the project has to be balanced against the developer's need to carry out the work in an effective manner.

A particular problem arises if the building is not fully occupied when the property is due to be handed over to the buyer. The formal handing over is often combined with the completion inspection which is carried out by an independent inspector. It is often subject to much discussion how tenant improvements which are not yet complete (and hence not included in the inspection) should be dealt with. Should all premises be fitted-out to a certain standard regardless whether the area is let or not so that no further inspection is needed? Should the purchaser have the right to deduct part of the purchase price and carry out the required works himself? How should, in such an event, the remaining tenant improvements be priced?

### **Timing issues**

The time-table in a project of this kind is very important. However, the more unknown factors there are, the higher the risk for delays. In some projects the required zoning plan is not yet established at the signing of the agreements. Due to the fact that such a plan is often subject to appeal by the general public, delays are common in this process. Since building permits may not be granted before the plan has gained legal force, such delays will have an impact on the whole building process. There may of course also be other sources for delays but in our experience the time needed to establish the zoning plans is one of the most difficult to predict.

With regard to the construction works the construction contract needs to be adjusted to allow for the time factor; which may sometimes be difficult

to predict. This can of course cause specific problems in relation to the contractor, who needs to provide a substantial work load at a future time which may be undetermined.

### **Payment and guarantee issues**

One important issue related to the construction agreement is how payment is to be made for the development works. Such works are typically paid for in instalments, and it is important to make clear in the sale and purchase agreement that the investor will not have to pay double compensation, i.e. compensation both through payment of the purchase price and through payment from the acquired company to the contractor. Specific attention should be paid in this regard to payments to the contractor that become due after the investor has taken possession of the company.

The general construction guarantee in Sweden has normally been the length of two years from the approval of the project at the completion inspection. In an international comparison this has been considered to be too short, and in the latest versions of the standard contracts the guarantee period has been extended from two to five years. Although not stated in the standard contracts, additional guarantees are usually issued by the suppliers of certain materials such as roofs and windows. Such guarantees are often valid for between five and 10 years.

### **Summary**

The contract bundle needed for a forward funding or forward purchase acquisition is both complex and extensive. There is not only a sale and purchase agreement to negotiate, but often also a project management agreement as well as a construction agreement. In addition there may be different kinds of

agreements with external parties that need to be negotiated or considered, such as exploitation agreements with the affected municipality.

What makes this kind of deal especially challenging and demanding is that the factors which are decisive for the value of the project are unknown and need to be foreseen and regulated in the contracts. Basic factors such as the ratio between let and vacant space, the rent levels, the quality of the building etc. need to be determined and, as mentioned above, there are a number of connected issues to consider in relation to each of these factors.

This kind of project obviously puts high demands on the involved parties. All issues which typically occur over a number of years need to be foreseen and regulated in a number of contracts at one time. It is obvious that all situations cannot be foreseen, and the parties often try to add various types of 'good faith' clauses to cover these situations. Such clauses will clearly only be vague guidelines in a concrete situation and we believe that a trustful co-operation between the parties is absolutely essential in order to complete the project successfully.

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