Commercial Property Values Dependant on Strata Law

By Gary Bugden*

UAE strata laws and the way they are applied will play a major role in determining the countries' commercial real estate values in the years to come. This article examines the reasons why that is the case.

A large proportion of real estate developments in the UAE and the Region generally, both communities and buildings, comprise a mixture of uses. While mixed use communities are relatively easy to deal with under modern "strata" laws, mixed use buildings can present a myriad of technical challenges, depending on their size and complexity.

The majority of mixed use buildings simply comprise residential apartments with a small number of retail shops at ground level. In most cases these types of buildings can be adequately dealt with using a standard strata title solution tailored to deal with the special needs and circumstances of the retail component.

The complex variety

However, a significant number of mixed use buildings are large and complex, comprising a range of uses, some of which occupy large floor areas that are very valuable in their own right (such as a hotel, office tower or large shopping mall). These are institutional investment grade buildings that are likely to be attractive, in whole or in part, to institutional investors, such as large corporates, real estate investment trusts (or REITs), superannuation funds and sovereign wealth funds.

It is not uncommon to encounter a large mixed use development that comprises say a shopping centre, hotel, commercial offices and residential apartments. This type of development is commonly regarded as a number of separate buildings that interact with each other. However, a closer examination often reveals that they share car parking areas as well as a range of services and facilities. The basement is usually the area that presents the most complexity because it is shared by some or all of the component use areas. The reality is that this type of development is actually a single building that comprises a range of different but interdependent uses.

For this type of building there is a need for the developer to devise a subdivision, title and management strategy that will enhance the value of the various components, particularly the non-residential components, and ensure smooth operation of the overall building post completion. There are a range of options available when devising such a strategy and the choice of the most appropriate option is critical for the developer, as well as subsequent owners.

Volumetric subdivision

The option that institutional investors are most comfortable with involves a volumetric subdivision of the entire building. This creates what is essentially a commercial environment in which the interests of the owners of the various component use areas can be quarantined and nurtured to the maximum extent. For commercial real estate, the volumetric subdivision provisions of strata laws are critical. As the real estate market in the UAE matures and develops into a true international investment market they will provide the means to protect the value of significant commercial components of mixed use buildings.

See insert for an explanation of volumetric subdivisions.

Applying the Strata Law

While the mechanisms introduced by Strata Laws are very important, the key challenge for developers and their consultants, as well as the regulators, will be the way in which they apply the Law. The Law contains a range of structures that can be used for particular buildings. Choosing the right structure for the building and properly implementing that structure will be critical to maximizing the value of commercial components of the building and minimizing future operational conflict. Because of the range and complexity of issues involved a multi-disciplinary approach is essential to the choice of structure and its implementation.

Key issues

Apart from choosing the right structure, some of the issues associated with volumetric subdivisions are:

- Placement of title boundaries – which determine ownership of usable areas as well as "shared elements". (These shared elements comprise areas, facilities, equipment and services that are owned by one component use owner but used by two or more other component use owners. They are fundamentally different to "common areas" of an Owners Association which are owned jointly by all of the owners who constitute the Association.)
- Cataloguing of shared elements for volumetric plot owners and delineating common areas for Owners Associations.
- Identification of rights and obligations of the various stakeholders that need to be created to ensure the smooth and equitable operation of the building.
- Allocation of costs associated with the maintenance of shared elements, including renewal and replacements costs.

- Allocation of maintenance responsibility and decision making in relation to shared elements (i.e. the administrative arrangements).

- The quality of legal documentation, which is heavily dependent on the outcome of the work involved in resolving the above issues.

The value proposition

Developers and investors with large mixed use projects should move quickly to preserve the value of their properties by ensuring that they are properly sub-divided and titled under strata laws. This can be an expensive process, although in Dubai the Land Department has initiated a "transitional process" involving relaxed requirements that substantially reduces some of the surveying expenses. When doing the "cost/benefit analysis" of undertaking this process developers and investors should keep in mind the magnitude of value loss that can occur if the right solutions are not found.

On 22 May 2010 *Gulf News* quoted a Director of CB Richard Ellis (CBRE) as saying that "*Corporate global clients don't want strata buildings. The truth is that the value of a single asset building is 15 to 30 per cent higher than a strata one*." While this concern about strata titles relates to the "internal" subdivision of commercial components, it also extends to commercial components of large mixed use buildings that are caught under the umbrella of a strata Owners Association. Such an outcome also affects the value of the commercial component, usually between 6 to 10 per cent in mature markets (although some professionals would argue for a higher range).

The UAE mechanisms

The volumetric subdivision mechanisms introduced as part of existing and proposed strata laws for the UAE have been specifically designed to address the reluctance of institutional investors to purchase strata title properties. They ensure that commercial components in large mixed use buildings are preserved as a single entity free from the dictates of a strata Owners Association. They have been proven internationally to preserve and enhance the value of commercial components within a mixed-use building provided they are properly planned and implemented.

Their key functions are to:

- Avoid the imposition of an Owners Association over valuable commercial components of a building.

- Allow a more flexible approach to applying rights and obligations to the owners and occupiers of the various components of the building (such as controls over services, decision making and cost allocations), than would otherwise exist under an Owners Association.

- Separate the interests and influence of commercial and residential owners.
- Create a commercial environment in which the commercial components operate.

The Challenge

The flexibility introduced by volumetric subdivisions presents a challenge for regulators, particularly in the Dubai environment where developers typically imposed grossly unfair arrangements on property owners. However, it will be critical for the future of the country's real estate industry for regulators to understand and properly apply these new mechanisms. Regulators must not distort the mechanisms and circumvent their intended purpose. Instead they should focus on essential protections for consumers, while recognizing that owners of commercial components of buildings do need special arrangements in place to protect them against interference from non-commercial owners and, particularly, Owners Associations.

As the UAE real estate market matures, institutional purchasers and financiers will increasingly require comprehensive due diligence investigations to be undertaken on commercial components of mixed use properties. The outcome will have a bearing on the value of those components and on the price being paid or loan being advanced. Investors and regulators alike will then come to understand the importance of applying the volumetric subdivision mechanisms in the way they were intended.

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Volumetric Subdivision

- Subdivides a building and its land into "volumetric plots" (i.e. component use areas)
- Defines boundaries 3 dimensionally using spatial co-ordinates
- Volumetric plots comprise all of the original land parcel
- No jointly owned property (common areas)
- No Owners Association
- A volumetric plot (e.g. the residential component) can be strata subdivided to create jointly owned property and an Owners Association - both being confined to the (residential) volumetric plot
- Facilities, equipment and services within a volumetric plot (which are owned by the owner of that plot) that are used by 2 or more other volumetric plots are called "common elements"
- Rights and obligations regarding common elements (including maintenance and cost sharing) are set out in a contract called a "Building Management Statement"
- The Building Management Statement is a commercially focused document and secures the essential arrangements for the commercial owners
- The Building Management Statement automatically binds purchasers and mortgagees of a volumetric plot.