Education real estate assets in the UAE: what happens next?

Ian Arnott - Head of Hospitality Development - Real Estate
i.arnott@tamimi.com - Dubai International Financial Centre

In this article, we look at the current state of the UAE market regarding educational real estate assets and look at some possible near to mid-term future trends.

Rent mismatch

There was already a mismatch in the UAE market between the unrealistic rental/yield expectations of school owners and investors and the actual revenues of tenants/operators. This was particularly true with regard to school operators' occupancy pursuant to the glut of sale and leaseback transactions seen in the last decade. These types of deals have been favoured by institutional investors, funds and REITs and often involve the operator/tenant taking a "triple net" lease, where the tenant assumes all of the usual obligations of the landlord regarding repairs and maintenance and insuring the buildings. Then COVID-19 appeared out of nowhere and the school experiment began to further unwind. The Bunsen burner fell over. The litmus paper turned a funny colour. Someone threw a chunk of caesium into a large glass bowl of water and it exploded and cracked.

The educational landscape, come the beginning of the new academic year in September. remains uncertain. Enrolments are likely to be down. There are likely to be increased operating expenses in ensuring compliance with relevant authority safety protocols. With the school closures for the last part of the 2019/2020 academic year and a move to distance learning, schools were forced to introduce fee discounts. Even if most children are able to return to school in the Autumn (albeit it in a very different way), it may be difficult for schools to bring back fees to pre COVID-19 levels – particularly if the size of the school means that a percentage of children have to remain at home pursuing their learning online on a rotational basis. Also, given the general economic headwinds, it is probable that there will be an increase in incidents of non-payment of fees by parents. The possibility of a future resurgence in new COVID-19 cases and the reintroduction of school closures and lockdown measures can also not be ruled out. All of these factors serve to ramp up the pressure on operators' levels of revenue and the ability of them to meet their rent obligations.

What has often been skipped over in discussions regarding commercial leases in the midst of COVID-19, is the pressure that landlords also face if tenants default on their rent payments; particularly if there is debt secured over the property that needs to be serviced or there are investors expecting a certain level of return. Measures such as placing a moratorium on evictions, if just used in isolation, can serve to tie the hands of owners to take action and can encourage tenant breach.

Solving the rent mismatch problem therefore requires an holistic approach which seeks to strike a balance between the interests of tenant/operators, landlord/owners and lenders. How this plays out remains to be seen but the relevant stakeholders will need to take a realistic and pragmatic approach to agree upon new commercial arrangements moving forward. This could be through the renegotiation of rent payments; through rent waivers; deferrals; or the introduction of profit share/turnover rent arrangements that are common in retail and F&B leases. We may also see owners looking to protect their position by taking, for example, an equity share in the operator business in order to offset a reduction in rent payments. Business plans are also likely to be under preparation for potential debt restructuring between owners and lenders.

The success of such rent negotiations and restructurings will largely depend upon whether the asset has solid, long term fundamentals, for example, value for money offerings located in the centre of communities with a captive base of families that does not wish to travel long distances on a daily basis or overpay.

On the issue of varying existing leases to reconfigure tenant payment obligations, tenants should be mindful of the fact that the COVID-19 pandemic is a particular and rare type of force majeure event. It is not like a hurricane or a flood which is sudden and localised and where the relevant effects and losses can be quickly assessed and quantified. It is a protracted, global event where, even though its general occurrence is known, the exact nature of how its effects will manifest themselves is uncertain. A similar type of force majeure event would be a world war. There is, therefore, the potential for smaller, unforeseeable force majeure type events to occur in the future within the overriding context of the known pandemic. Is a second wave of the virus and a future long term closure of the school foreseeable? Perhaps, but it is debatable. Any variation of an existing contract resets the position regarding the question of foreseeability of an event by the contracting parties. Due to this mix of the known and the unknown regarding the ongoing pandemic at present, it is best to take any future concerns or agreed protections regarding its future effects entirely out of the force majeure regime and deal with such matters separately and explicitly in the variation of the existing contract. The same applies to new agreements being entered into at the current time.

Consolidation and amalgamation

In June, it was announced that two American schools in Sharjah would be merging operations into one campus for the 2020/2021 academic year in order to reduce operating costs. This move was undoubtedly brought about due to the challenges being faced by school operators in current times as described earlier. Such an amalgamation of premises between schools may be a trend that is set to continue in the near future.

In addition, we may also see some of the big operational players eyeing up mergers and acquisitions regarding those smaller operators currently in distress. This may be a trend that develops post-September when there is more clarity regarding the exact nature of the new educational landscape in the UAE.

We may also see an uptick in sale and leaseback transactions, albeit it configured in a more realistic way, with owners looking to release cash from their ownership of non-liquid real estate assets, whilst still requiring the asset to operate.

Repurposing

With a large portion of the workforce working from home and the general shift to online interaction for the past few months, commercial tenants across the world are now rethinking the use and configuration of their commercial space and whether some of it may be surplus to requirements. This has accelerated a trend that was already in motion prior to COVID-19. The bricks and mortar real estate industry is being disrupted by technology.

In the context of education, blended learning, where students learn through a mix of online interaction and traditional face-to-face teaching, may be here to stay. This could lead to operators seeking to downsize their space requirements or lead to the amalgamation of premises, as discussed above. This could lead to owners having to repurpose the whole or parts of their educational assets for different uses.

In addition, and in a worse case scenario, for those owners and operators that are not able to navigate their way through the current rent mismatch and restructure commercial arrangements/debt obligations, and where smaller operators continue to bleed and are not snapped up by bigger fish, we could see a spate of lease terminations, as part of a wider insolvency crisis, with such buildings never to return as educational facilities and needing to be used for something else.

One further point; educational establishments in the UAE are renowned for the scale, variety and quality of the facilities that they offer. A way for operators to increase and widen potential revenue streams could be to allow for such facilities to be opened up out of hours for alternative activities and use by external customers. However, this may involve incurring greater operating expenses and a cost/benefit analysis would need to be carried out.

Silver linings

COVID-19 has accelerated and intensified problems that were already in play including, amongst others: the rent mismatch; unrealistic expectations; and a lack of focus and consideration on what types of products really work in the market. The current crisis could see a welcome injection of realism; a much needed correction; a Darwinian weeding out where fundamentally solid and sustainable offerings have adapted and are well placed to survive long term. We shall see.

For further information, please contact Ian Arnott (i.arnott@tamimi.com).