



OAK INVESTMENT MANAGEMENT GROUP



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Change of use in Real Estate

Physical real estate is regulated in various forms and in various guises. Depending on the country and the jurisdiction there are different permitted categories for which real estate can be used. These can be borne out of health and safety, practicality, zones of ambiance or central planners' predilections. Like any regulations these designations can have various degrees of legitimacy – and changing the specified use of a building can be encouraged, opposed, allowed or denied by a competent local or state authority.

From a commercial point of view, there is usually a change of use arbitrage. This means that dependent on the ability to get acceptance from the authorities to change categorisation, a piece of real estate can be worth more in the market. This can be an alluring target for an owner – but the hurdles to this change cannot be under-estimated. Dealing with the bureaucracy, the unjustified politics or the justified stakeholders' interests can weigh down a change of use plan.

By far the most value accretive use designation in the right to build in the first place. Fortunes have been made throughout the world on the basis of converting a field into buildable zone. The more this is restricted the more the ability to understand and make this happen will result in ever greater payoffs for the developers / owners of the land and the option.

The highest end value real estate by far (excepting very specialised categories of real estate) is invariably residential. This means that all things being equal any chance to convert any industrial, retail or office real estate into residential has to be examined. Added to this residential it is also the sector which for one reason or another is entitled to more leverage than any other segment. This means that residential is a high levered beta with concomitant consequences in good and bad times.

However, residential is not only by far the biggest sub-sector in real estate but it is also the one with the largest stakeholder base – from neighbours, municipal, local and national authorities. It is a source of envy and it is an easy target of the tax authorities. This is a natural 'break' on supply but there is also a market 'break' with a natural persistent balance between the various uses of real estate. Authorities should allow fluctuations in these balances to occur in order to allow the pricing mechanism to filter through the real estate market – without this, dangerous imbalances will occur.

It is important to appreciate that the more uses are protected the higher the arbitrage will be between the use classes. Ultimately no public authority can stand in the way of the market and how it rewards success and punishes failure. National and European policymakers need to appreciate that they can make more with the market than against the market.

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