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Advisory | Distressed High Yield Bond Workout Group

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Workouts and Remediation of Student Housing Project Bonds

For more than three decades, universities and colleges have increasingly relied on off-balance sheet financing of student housing. Such financing structures allow universities to compete with other colleges in providing attractive new student housing, while not straining the institution's credit. Off-balance sheet student housing projects can be financed by third-party student housing management companies, equity investment by third-party developers, taxable project-based bonds, and tax-exempt project-based bonds.

This GT Advisory focuses on projects financed with project-based bonds, both tax-exempt and taxable.

Ongoing financial pressures in the student housing sector

Projects financed with bonds can be broken into two categories, bonds rated by S&P, Moody's, or another rating agency; and nonrated bonds, which tend to have lower levels of credit protection for bondholders.

The entire rated student housing sector was downgraded by S&P and Moody's in early 2020 in the face of plummeting occupancy during the COVID-19 pandemic. Although the sector has generally rebounded, a number of rated projects remain downgraded because of continued pressures.

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A recent S&P review of rated bonds in the student housing sector notes that "most privatized student housing projects [are] structured with limited capacity to build their financial resources through ongoing operations, usually reporting just above their covenanted debt service coverage every year. Therefore, when occupancy drops significantly, most projects have very little in reserve."[1]

In the riskier, unrated side of the market, a number of well-publicized covenant defaults, draws on reserve funds, and a declaration of bankruptcy by a bond-financed project at University of Florida show the pressures on this market.

It is therefore timely for bondholders, bond trustees, and providers of credit enhancement to consider remedies and workout strategies in their student housing bond portfolio. This memorandum addresses strategies and approaches to student housing defaults, for bondholders and other creditors.

Covenant and structural features of a bond-financed student housing project

Student housing bond deals typically have a project finance structure, which means the bonds are secured solely by project revenues and assets, the bond debt is non-recourse to the university, and the bond debt also is limited recourse to the borrowing entity. The source of payment is project revenue in the form of lease and sublease payments. The bond financing provides a full 100% of the project costs. The maturity of the bonds are limited to useful life of project, typically 30-40 years.

Ground lease-sublease

The university provides property via ground lease, and ownership reverts to university upon payment in full of the outstanding debt. Because the mortgage is on the leasehold granted to the developer-borrower, who is independent of the university, the project generally remains off-balance sheet. Having a ground lease allows the university to regulate and supervise the project, and to receive annual ground-lease payments, albeit at the bottom of the payment waterfall funded by tenant lease payments.

Typical financial terms and covenants

Financial covenants typically require the project to maintain a minimum 1.20 times debt service coverage ratio, with a fully funded debt service reserve fund consisting of one year of maximum annual debt service (MADS). Furthermore, capitalized interest is typically funded six months past the scheduled initial occupancy of the project. In most cases, a replacement reserve for capital improvements is established. Sometimes, there is an operating reserve fund. Through the use of a 501c3 entity as the borrower, the project can be exempt from federal, state, and local income tax. The project is generally exempt from ad valorem property taxes.

Relationship with university

A typical bond-financed student housing deal has most or all of the following obligations on the university: to include the project as part of its housing stock; to provide marketing assistance to the project; to withhold grades and transcripts in the event a student fails to pay rent; to provide additional support in the form of first-fill agreements and occupancy guaranties; and to agree not to overbuild, often via a market verification study before construction of new student housing, or an agreement not to compete. If the 501c3 borrower entity is a charitable foundation the university controls, rating agencies

[1] S&P Global Ratings report *U.S. Privatized Student Housing Occupancy Rebounds; Ratings Will Take Longer To Recover As Projects Recoup Losses*, Oct. 17, 2022.

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generally treat the university as having a moral obligation to the project, which is then off-balance sheet but "on credit," in contrast to an independently controlled 501c3 borrower.

Management

A stand-alone bond-financed student housing project can be managed by a third-party management company, the university, or both. They are responsible for operation, management, maintenance, repairs, and residence life programming. Under the federal tax code, management company compensation cannot be tied to profitability of the project, but rather is a set fee within strict parameters.

Considerations upon a covenant default or indications of serious performance issues

Upon major signs of impairment, the bond trustee and/or significant bondholder should organize a bondholder group to coordinate the response and to direct remedies if necessary. Professionals should be hired, including legal counsel of the trustee, who should perform a collateral audit. In student housing deals, particular care should be taken in reviewing the ground lease/sublease structure. One important consideration is whether the ground lease cross defaults to the bond documents, which would mean the lessor university would have rights of remedy if true. An uncured event of default of tenant under the ground lease usually grants the university the right to terminate the ground lease, which would potentially eliminate the trustee's collateral. Understanding whether this situation exists can dictate strategy, including invoking the bond trustee's right to cure; which strategy in turn can be affected by how committed the university is to the financial success of the project (see below) or whether, alternatively, the university might be seeking a pretext to terminate the ground lease and take control of the project.

Another consideration is whether to appoint a successor trustee. This can depend on whether the transaction was initially rated or non-rated. A bond trustee may have different expectations about its potential role when it has been engaged in a rated transaction as opposed to a non-rated one.

Another typical step can be to change the management company. What are the problems? If the problem is low occupancy due to lackluster programming at the dorm and poor marketing, a new management company may help improve things.

Bondholders may also apply the standard creditor toolkit, using forbearance agreements and waivers to set up incentives and guideposts and protections to allow the borrower time and parameters to turn itself around.

And probably the most important consideration of all in the case of an off-balance sheet student housing deal: WORK WITH THE UNIVERSITY – enforce agreements, address rent payment problems due to financial aid disbursement timing, seek direct financial support. Depending on how important the project is to the university, it may be possible to obtain improved financial support (to the extent the following are not already part of the agreements governing the deal): Get the school to guaranty debt service coverage. Get the school to master lease some beds in order to increase formal occupancy. Get the school to agree to keep the debt service reserve fund funded.

If the project suffers from lack of competitiveness due to deferred maintenance issues, the fact that reserves don't usually build up can be an impediment to turnaround. In this case, bondholders may have to fund capital improvements, usually by agreeing to apply the debt service reserve fund and/or forgoing debt service payments and instead applying the (impaired) revenue to capital improvements, and then stretching maturity to allow the extra debt to be repaid or conduct other modifications.

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Note that this memorandum does not address defaults related to construction delays and other issues prior to completion, which require their own unique strategies.

Considerations after a payment default

When a project is seriously impaired and not making debt service, receivership may be considered. It allows the appointment of a receiver for oversight of the project, to put it up for sale or to marshal assets for a turnaround. However, because the sale of a leasehold interest away from the 501c3 borrower will usually result in imposition of ad valorem property tax on the real estate, pricing of the project in a sale will need to factor in the additional costs of these taxes. Transfer of a real estate asset can also trigger transfer, sales, and excise taxes and/or fees. A downside of receivership is additional costs.

Conclusion

Remediation and recovery for bondholders and other creditors in a bond-financed student housing project requires bringing numerous strategies and actions to bear, from forming a bondholder group to negotiating support from the university to diverting funds for capital improvements to receivership to sale. It should be done with the advice and assistance of experienced counsel.

Read about GT's Distressed High Yield Bond Workout Group.

Author

This GT Advisory was prepared by:

- Carl McCarthy | +1 407.254.2661 | mccarthyc@gtlaw.com

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