



Critical COVID-19 Issues Facing the UK Real Estate Industry

The State of the UK Real Estate Market for Debt Finance

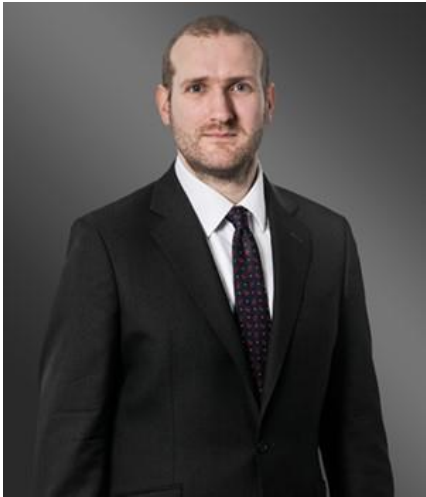
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What Is Happening Out There?

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- The most immediate impact of the Corona Crisis is that Occupational Tenants are not paying rent to their Landlords.
- This means that Landlords are unable to pay interest to their Lenders.
 - This behaviour is not sanctioned under the Coronavirus Act 2020 (the “**Act**”).
 - To put it crudely, Landlords cannot compel Occupational Tenants to vacate their Properties while the protection of the Act remains in place. This has provided Occupational Tenants with a level of defence in not paying rent - even when they can.



**What Does This Mean For
Landlords And Their Lenders
Most Obviously?**

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- There are some implications that are very clear.
 - Some Landlords are in breach of the payment obligations owed to their Lenders because they are not being paid by their Occupational Tenants. Clearly, that is an Event of Default.
 - Even if a Landlord is not in breach of its payment obligations, there is a high degree of likelihood that the Landlord will be in breach of the Historic ICR Covenant or the Debt Yield Covenants, which are calculated on the basis of Net Rental Income actually paid. Clearly, that is also an Event of Default.
- It is highly likely that LTV covenants will be under stress as well. However, as these are measured at the moment by reference to the most recent valuation, the stress may not be revealed at the moment. Clearly, that is also an Event of Default.
- It should be noted that the Projected ICR covenant is different from the Historic ICR covenant - just because Occupational Tenants have not paid rent in one quarter does not necessarily mean that they won't pay in coming quarters. A Lender may have to give credit for a tenant that is in arrears unless rent from such a tenant is specifically carved out from the Projected ICR calculation.



How Are Lenders Approaching These Matters?

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- On the whole we are finding that Lenders are being supportive and that Landlords are being responsible.
- This may be regarded as a “**Waive and Wait**” approach.
 - Where there is a payment default, Lenders are deferring the obligation to make debt service payments. They are not, however, writing off the obligation to pay interest and the unpaid interest will be treated as an “Unpaid Sum” and will continue to accrue interest, though not necessarily at the default rate which the Lenders are entitled to charge.
 - Where there is an ICR breach or a Debt Yield breach, Lenders are waiving them on an Interest Payment Date by Interest Payment Date basis.
 - Where there is an LTV breach, Lenders are again waiving them on an Interest Payment Date by Interest Payment Date basis.

How Are Lenders Approaching These Matters?

- There is one anomaly in the LMA Form that it is worth Borrowers being aware of.
- This is that financial covenants are required to be in compliance **at all times**, even though they are only tested on a quarterly basis.
- There is a logic to this in an ICR and Debt Yield context - the calculation can change at any time. However, this means that even if a Lender waives non compliance by reference to an Interest Payment Date, there could be an actionable breach on the very next day.

How Are Lenders Approaching These Matters?

- What we are not seeing is Lender's taking enforcement action in the strict sense by appointing receivers or administrators. There is limited merit in seeking to take such steps where the sponsor is willing and able to work responsibly and collaboratively with the Lenders.
- Nor are we seeing Lenders looking beyond individual Interest Payment Dates.



**What Other Matters Are
Relevant In The Functioning Of
Loan Agreements - Cash
Trapping**

What Other Matters Are Relevant In The Functioning Of Loan Agreements - Cash Trapping

- Even if a Lender is willing to waive a financial covenant breach it should consider very carefully whether to waive a Cash Trap covenant. While there is logic to a Landlord wanting to have access to any available excess cash flow to fund operating expenses, it is difficult for a Lender to reconcile giving up available cash flow which might be needed in the future.
- **There are two alternative approaches:**
 - The Landlord should approach the Lender when it requires Cash Trap Amounts to be released. This, of course, gives a discretion to the Lender.
 - The Landlord creates an operating expenditure budget which is agreed with the Lender and for which funds will be released provided that there is certainty that there will be funds available to make debt service payment on the next Interest Payment Date.



**What Other Matters Are
Relevant In The Functioning Of
Loan Agreements –
Assignments And Transfers**

What Other Matters Are Relevant In The Functioning Of Loan Agreements-Assignments and Transfers

- Our experience is that Landlords are recognising the importance of relationship lending and making sure that they are not taking the risk of having a hostile Lender. We are acting for a Lender who has agreed, at the request of the Landlord, not to transfer the Loan for a certain period even though it has the right to.
- This flies in the face of the freedom to transfer that Lenders typically bargain for.



**What Other Matters Are
Relevant In The Functioning Of
Loan Agreements –
Construction Matters**

What Other Matters Are Relevant In The Functioning of Loan Agreements-Construction Matters

- **There are two real world concerns here:**
 - The first is that supply chain disruption has had a bearing on the availability of construction inputs.
 - The second is that contractors are also suffering from very significant financial distress and do not necessarily have the ability to continue with their work.
- The matter that Lenders need to consider are what restructuring needs to be done in respect of a cap ex or construction programme and what implication this has, if any, for other contractual provisions such as the final maturity of a Loan.
- This is an area in its own right and we will organise another webinar on it but for now, matters that require particular focus are whether, as a matter of fact, cap ex or construction work is proceeding as scheduled and if not why that is the case; are the existing construction team able to perform their obligations or are they impacted by financial distress themselves; and what are the alternatives to the original construction team continuing the work.



**What Do We Think Is Likely To
Happen Next?**

What Do We Think Is Likely To Happen Next?

- What has happened in the last few weeks is really only the beginning in terms of how Loans are likely to behave.
- At the expense of generalising, commercial real estate is now an impaired asset class. There is a distinction to be drawn between the Global Financial Crisis and the Corona Virus crisis. In the Global Financial Crisis financial markets were impaired but Occupational Tenants paid rent and so Landlords could pay their Lenders - until it came to maturity. That is not the case now.

What Do We Think Is Likely To Happen Next?

- It is not right, however, to talk about impairment as a singular phenomenon. It is possible to categorise impairment into two types: structural impairment and non-structural impairment.
 - Structural impairment is intended to cover commercial real estate assets which will not necessarily be the same again because the world has changed. The most obvious example of this is retail where a change in the approach to shopping; the financial distress faced by retailers large and small; and the severe dent to consumer confidence is likely to mean that the impairment of retail assets is long-term. The same could be true, albeit to a lesser extent, to the hospitality sector, particularly in relation to business travel.
 - Non - structural impairment is more transitory. Examples of asset classes where we expect impairment to be more transitory is co-working assets; co - living assets and BTR/PRS.



**The Difference In Approach
Between Structural and Non-
Structural Impairment**

The Difference In Approach Between Structural and Non Structural Impairment

- Our analysis and expectation is that Lenders and Landlords will need to undertake some level of fundamental real estate analysis to determine where assets that they are exposed to are subject to structural or non structural impairment.
 - Where there is non - structural impairment, the fundamental question should be how long the impairment will continue and can debt service be met for this duration and how.
 - Where there is structural impairment, a more fundamental question needs to be considered. This is what can be done with structurally impaired assets and how can such radical repositioning be financed and organised. It is possible but it will not necessarily be easy for Landlords or for Lenders.
- It seems to us that Lenders and Landlords should be proactive in relation to this.



**Determining How Best
Available Cash Flow Can Be
Used**

Determining How Best Available Cash Flow Can Be Used

- The other thing that we think should happen is Lenders and Landlords working collaboratively to ensure that such cash flow as is available is applied to protect the value of the assets as far as is possible.
- It may be preferable for available cash flow to be used for the purposes of operating expenditure or indeed capital expenditure rather than deleveraging.
- It is particularly important that critical payments such as Headlease rent and insurance premiums are paid.



The Implications Of Lenders Own Funding Arrangements

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- Finally, Lenders should be looking at their own funding sources to see how stress in respect of Loans could have an impact.
- For bank lenders who rely on deposits or interbank borrowing, the implications are likely to be less severe than for debt funds that have used funds from limited partners or from separate account mandates or who have loan-on-loan funding arrangements, which are subject to performance tests.



How Should The LMA Form Evolve?

How Should the LMA Form Evolve

- The LMA Form of Facility Agreement is actually a fairly sophisticated tool and provides a framework for Lenders and Landlords which is reasonably well referenced.
- However, we can see some merit in its evolution. There are four specific provisions which we have identified:
 - The first is the requirement, contained in the Property Undertakings, is in relation to a Borrower being under an obligation to obtain payment of the rent from Occupational Tenants. This is an absolute obligation - and one that is not possible to perform. This should be relatively easy to refine so that it is qualified by a reasonableness standard.
 - The second is the requirement that debt service payments are always made from funds held in the Rent Account and that the only amount that can be paid into the Rent Account is Net Rental Income. It is quite possible that at least in the case of an asset which is not subject to structural impairment that sponsor support will be forthcoming by way of subordinated debt which should be paid into the Rent Account.
 - The third is in relation to the financial covenant cures. Prior to the Global Financial Crisis, Lenders would allow ICR covenant breaches to be cured by the sponsors “topping up” shortfalls in rent. This ceased to be available because Lenders felt that it allowed Landlords to paper over the cracks too easily. It may be worth considering whether Landlords should have enhanced cure rights so that ICR covenants do not have to be waived and a Cash Trap Amount can be built up.
 - The fourth is the insolvency related Events of Default, where even seeking a compromise with creditors can trigger an Event of Default.



The Market And What We Are Seeing

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- Unlike 2008, there is actually still some new lending happening and a number of Lenders have told us that they are still open for business.
- However, the lending we are seeing falls into two categories:
 - The first is relationship lending where lenders are continuing to lend to their long standing clients in order to support them.
 - The second is where a loan has fundamental merit - low leverage industrial with strong sponsor support and good tenants.

The Market And What We Are Seeing

- What we are not seeing is much appetite for transactions with “hair”. Speculative development has always been tough but now it is very tough indeed, even with sponsor guarantees, because it may be hard to assess the credit quality of a sponsor. Retail has been tough to finance for a while now but the Corona Crisis has accelerated the structural impairment.
- The market for commercial real estate debt is infinitely more diverse than it used to be at the time of the Global Financial Crisis. New Lenders are emerging regularly and strange as it may seem Fin Tech related debt solutions are also emerging for the real estate market. We hope that this trend will continue and that new lending will continue while the necessary restructuring of existing Loans continues in parallel, particularly where there is structural impairment that needs to be addressed.



Conclusion

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- The Corona Crisis has taken all of us by surprise.
- While Waive and Wait is probably the correct first instance response in our view it needs to transition to a more long term approach where appropriate solutions are found for assets that are both structurally impaired and those that are non structurally impaired.
- There should be an expectation of losses on lending: CASS has recently estimated that losses on loans backed by retail assets will be £10 billion.

Questions?





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