LEGAL PLATFORM

HEADS OF LEGAL EXPERT PANEL OUTPUT PAPER

**AFB Expert Panels meet regularly and produce Output Papers on behalf of the whole membership (see Note).*

REAL ESTATE FINANCE POST COVID-19

A. SUMMARY

This paper reflects the discussion at the meeting of the Heads of Legal Expert Panel held on Thursday 2 July 2020 on the changes in the real estate finance market as a result of COVID-19 (either directly or indirectly). The discussion was led by Marc Gilston, Rich Hughes, and Imogen Benson, Real Estate Finance Specialists at TLT Solicitors. Their contact details can be found on page 5.

The re-negotiation of banking documents is high on the agenda for a growing number of borrowers and lenders which are responding by approving financial covenant testing waivers, waivers of defaults and repayment deferrals together with authorising the use of the government-backed funding schemes (where available) to assist with bridging borrowers through this period. The changes that may result in the underlying real estate market and the updates required to the relevant loan documentation as a result of that were also considered, as well as a brief look at the impact of the Corporate Insolvency and Governance Act 2020 ("CIGA 2020").

B. KEY POINTS

1. Existing Deals

1.1. Initial Consequences

The session focused first on the changes in the real estate market which have occurred since the UK went into lockdown as a result of COVID-19 in mid-March 2020. It was noted that very few new commercial real estate financings have been seen since the start of lockdown. An attendee poll asked whether the institutions of those attending have appetite now for new money deals and, if so, if that appetite is in relation to new or existing customers, new or known real estate or a combination thereof. Encouragingly (and contrary to what TLT has seen) just over half of respondents confirmed that there is appetite for the financing of new real estate deals with new customers.

It was also stated that the enmasse renegotiation of existing banking documentation had been the activity mostly undertaken since the onset of COVID-19. These amendments have resulted in the inclusion of additional information requirements by the lenders. It was noted that the amendments required to deal with COVID-19 are not limited to the finance documents; underlying leases have also needed to be amended too.

The impact of IFRS 9 was briefly discussed and the potential issues it may have on the liquidity in the market (and the real estate finance market in particular). The COVID-19 period and any ensuing economic downturn is/will be the first time, since its adoption in 2018, that IFRS 9 will have wide use/implications. The changes introduced by IFRS 9 are significant in the context of defaulting/potentially defaulting loans and lenders will no doubt be carefully monitoring changes to their regulatory capital position caused by the increased impairments in their loan books. It was queried whether this change to the underlying accounting regime would impact on the way in which lenders are able to deal with customers where their risk profile has "significantly increased" since the loan was originated.

1.2 Existing Real Estate Finance Deals

1.2.1 Payment Schedules

Capital repayment holidays and the consequential increase of final repayment amounts and requests for interest roll-ups have been the most often requested amendments from borrowers as they struggle with their obligations. While lenders may be able to manage the current (increased) risk caused by COVID-19, there is, of course, an increased risk that the refinancing in due course will not be possible.

1.2.2 Waivers

Financial covenant testing waivers have been almost universally requested and have, in the main, been granted. There has been discussion about when and what will happen when the financial covenant testing resumes. The general position is that financial covenant testing will likely use only the post-COVID-19 numbers rather than the normal LTM approach financial covenants typically adopt.

In addition, various representations are being routinely suspended including the "no default" representation to obviate cross defaults which would otherwise likely occur. In the hospitality and leisure sectors a reduction has been seen in permitted (and required) capital expenditure and FF&E spend to ensure there is adequate liquidity for interest payments (and, to the extent relevant, principal repayment).

In certain circumstances, events of default have been waived, including the cessation of business event of default if such cessation has occurred as a result of governmental intervention. Changes have also been seen to the material adverse change event of default to carve out the impact of COVID-19 on certain businesses.

1.2.3 Lender Conditions

There is an increasing focus by lenders on the provision of management information as they need to understand (in a way that they have not done before) the current financial position of the borrower and what the COVID-19 recovery plans are. Some lenders are also including blocks or limits on dividend payments to ensure that a minimum liquidity level is retained. An increase in requests has been seen from lenders for security reviews/confirmations to check that the lender's security packages are robust and that the lender has the security which it requires.

1.2.4 Polls

A poll of AFB members present suggested that the most frequent requests made by borrowers are requests for: (i) financial covenant test waivers; and (ii) waiver of breaches for COVID-19 related events. A further poll ascertained that the most common amendments provided by AFB members are: (i) capital repayment holidays; (ii) financial covenant test waivers; and (iii) the waiver of events of default resulting from COVID-19 related events.

2. Asset Classes

The panel considered that the future of certain classes of real estate is uncertain: assets may need to be reimagined and, in order to future proof assets, changes of use may be required to ensure these assets retain a viable (and bank-able) income stream. A poll suggested that AFB members see: (i) warehouse/logistics; and (ii) clean energy as the real estate asset classes which have the most potential in the next 12 months.

2.1 Asset Classes with Potential

Retirement living, care homes, clean energy, warehouse/logistics and data centres are seen as attractive real estate asset classes post-COVID-19. Retirement living was already a growing sector but with the evidence of significant COVID-19 transmission risk in care homes and the stresses of lockdown isolation for the elderly, a retirement community has become more appealing for both residents and investors. Care homes remain attractive, in no small part due to government backed fees and the strategy to reduce the number of elderly patients in hospital.

Clean energy is also a growing sector and seen as a safe haven for investment. This is not only because of the issues with the global supply chain which have been highlighted by COVID-19 but also because both public and private entities are scrambling to meet the Paris Agreement (on climate change) goals. A global increase has been noticed in the clean and renewable energy.

Other sectors with potential include warehouses, logistics and data centres. As more and more of the retail market moves online, the need for these assets increases thus making them more appealing for investment. The increased demand for UK and European based data centres comes, in part, from the need for UK and European business to adhere to the European Union's (ever growing) data protection regulations.

2.2 Stagnant Asset Classes

There are a few real estate asset classes which are likely to remain steady as the fallout from COVID-19 continues to be worked through. These asset classes include industrial assets, residential property and commercial office space. The industrial sector has government backing and its importance could grow exponentially if the global supply chain continues to falter. Residential property is viewed as a stable asset class: the growing population (and the continued focus on home ownership) and with the PRS market holding its value, it seems sensible to conclude that this asset class may (continue to) provide steady returns.

Commercial offices have arguably been the most impacted in the long term by COVID-19 and recent Health and Safety Executive regulations require more space per person for an office to be COVID-19-compliant. Offices continue to be seen as being necessary to ensure the continued training of staff, the maintenance of business culture and to retain/maintain and enhance the mental wellbeing of employees. However, there may be some businesses which seek to reduce their office space substantially as the majority of their workforce continue to work remotely. It was noted that the smaller (and in particular, low rise) office buildings may be more successful as the shared spaces will not be (quite so) overloaded in the same way as a larger (high rise) buildings which may struggle to become useable whilst ensuring COVID-19 compliance.

2.3 Struggling Asset Classes

There are a few classes of real estate which may now struggle: these are likely to be retail and leisure, hospitality (generally) and student accommodation. With many universities taking the majority of the 2020/21 academic year online, the need for student accommodation has been vastly reduced.

There may be longer term issues for hotels as the volume of business travel reduces. It was noted that hotels in the United States are already adopting non-contact check-ins, the removal of shared spaces, the reduction of contact between guests and the removal of buffet options to help mitigate the COVID-19 risk.

3. Future Impact

3.1 Changes that may result from 2020

There are many changes anticipated as part of reimagining real estate and they will, as ever, vary with the specific asset, its geographical location and also the overall real estate market. An increase in requests is anticipated for security reviews as lenders shore up their position and consider future options (not least in relation to the impact of CIGA 2020 on enforcement action and asset recovery).

Real estate space will need to be reconsidered in order to ensure it is future proofed; the approach to this will almost certainly need to be flexible and allow for subsequent variation. Both lenders and landlords will need to consider consent requests carefully in relation to repurposing, reconfiguration, lease amendments and other changes to reflect COVID-19 compliance. Commercial landlords will have a number of issues to manage including the likely end of the upward-only rent reviews. There is also a growing expectation of changes to the planning laws to allow for repurposing and reconfigurations without the need for obtaining planning permission.

Valuations will be an area of increased focus. The methodologies used will probably need to change and be updated to reflect the new post-COVID-19 backdrop. In the context of real estate finance transactions, the methodology for the valuation to ascertain the LTV covenant will be key and is likely to be the cause of much debate.

The wider macro-economic downturn is likely to cause (and this is already evident) a reduction in the senior LTV levels which lenders will accept. This change appears to be allowing space for the re-emergence of “traditional” mezzanine debt.

There are many changes brought about by CIGA 2020. For the purposes of this paper the key is to understand that, whilst the economic outcome for senior lenders is almost certainly the same as with the previous insolvency regime, CIGA 2020 gives borrowers and their advisers a greater say in how the insolvency process will play out. The ability for directors (with the appointment of a monitor) to unilaterally implement a moratorium is fundamental to this change – lenders will be prevented from issuing enforcement proceedings during the moratorium.

In the final poll the members present were asked what early steps they are taking to deal with the potential uptick in amendments and waiver requests in 2021, following the moratoriums put in place to deal with the June (and likely September) quarterly rent payment dates. The responses suggested that a number of early steps are already underway, including (i) waivers, (ii) COVID-19 planning information requirements, and (iii) early refinancing.

3.2 Green Recovery

The UK government has confirmed that they plan to ‘build a green economy’ and ‘build back greener’. A “green recovery” has potential. There is huge interest in the market and the numbers of green deals are growing. Trade bodies have published guidance detailing the advantages of green loans and sustainability linked loan products and we are seeing their increasing use in real estate and non-real estate lending.

In the real estate space, the Green Finance Institute recently published its paper in respect of retrofitting homes to ensure residential homes become more energy efficient which would create new jobs, save energy and level up those areas outside London. The stage is set for a green recovery. Following the date of the session, the UK government confirmed a £2 billion scheme to assist homeowners with the cost of home renovation to increase energy efficiency.

C. RECOMMENDED ACTIONS

1. Review internal senior lender intercreditor principles and re-confirm these with credit to help ensure consistency and risk management when dealing with mezzanine finance providers.
2. Review standard form loan documentation (in particular the security documents) to manage the legislative changes introduced by CIGA 2020.
3. Consider updating the information covenants when providing waivers/making amendments to existing documentation to ensure that all of the management information required is provided within meaningful time scales.

D. NOTE

Meetings of AFB Expert Panels are held in compliance with AFB's Competition Law Guidance. All issues discussed are included in the relevant Output Paper. AFB holds a central record of all attendees at Expert Panel Meetings. AFB Expert Panel Output Papers are intended as general guidance and no action should be taken in reliance on them without specific legal advice.

E. QUERIES AND FOLLOW-UP

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2	Wells Fargo Bank, N.A.
3	Societe Generale
4	CaixaBank SA
5	Landesbank Hessen-Thuringen Girozentrale
6	DNB Bank ASA
7	Siemens Bank GmbH London Branch
8	Zenith Bank (UK) Limited
9	Silicon Valley Bank
10	S E B
11	ANZ Banking Group Limited
12	Cooperatieve Rabobank U.A.
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15	Bank of China
16	Sumitomo Mitsui Trust Bank, Limited
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