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Impact of COVID-19 on Financings Secured by Real Estate Assets

A lot of discussions have taken place over the past seven months or so in light of COVID-19 and the market reaction to it. The purpose of this client briefing is to share some observations with you from our recent experiences across our deals in the United Kingdom:

GENERAL APPROACH

Lenders are currently showing a degree of flexibility in their approach to defaulting and/or potentially defaulting borrowers. This is prevalent specifically in scenarios where the relevant events of default, and/or potential events of default, have been triggered by events outside the control of borrowers or where the loans were fundamentally performing pre COVID-19. Examples include retail tenants requesting payment holidays from their landlords (landlords being the borrowers under loan agreements) which has in turn triggered potential breaches with respect to interest cover ratio covenants. Lenders and borrowers are generally seeking to stabilize their lending arrangements.

MAE

At the start of the COVID-19 pandemic we saw a large number of enquiries as to whether a material adverse effect (**MAE**) under a loan agreement could be invoked to refuse funding or in some cases to call an event of default. On balance, lenders have remained cautious in their analysis of MAE (which is very complex and fact specific) and the use of the current COVID-19 outbreak to squeeze better terms from borrowers or for that matter to call an event of default. However, as the situation unfolds MAE will be something to keep an eye on, as will the question of whether lenders will come under increasing pressure to invoke MAE (notwithstanding the potential relationship and reputational implications of such action). Based on our experience, in real estate financing transactions, if an MAE has occurred it is very likely that other events of default would have also been triggered under the loan agreement, e.g. LTV or DSCR covenant breaches, and a lender will rely on those breaches to accelerate the facility or renegotiate more favorable terms, rather than relying on an MAE.

FINANCIAL COVENANT DEFAULTS

Real estate finance transactions have witnessed breaches, and potential breaches, of loan to value ratios (**LTV**) and/or interest cover ratios. Some lenders have been amenable to agreeing to LTV covenant holidays up to a period of one year (and the waiver of their rights to obtain property valuations at the borrowers' cost for the corresponding holiday period). This has in particular been the case in the retail sector and in relation to loans that were performing pre-COVID 19. Other lenders have agreed to equity cures of financial covenant breaches, with some lenders acting in a spirit of co-operation and going as far as waiving any prepayment penalties resulting from an equity cure. We have also seen an increase in the use of cash trap and cash sweep provisions under existing facility agreements to preserve cash in the structure and ensure the servicing of debt.

INFORMATION COVENANTS

We have seen lenders ask for, and borrowers agree to, enhanced information covenants, including the delivery of updated compliance certificates following a payment default by a tenant where the borrower is a landlord of a multi-let property.

BLOCK ON INVESTOR DISTRIBUTIONS

Some lenders are exercising their rights under loan agreements to block distributions to investors, thereby minimizing any leakage from the structure. Others are allowing for the release of funds to investors once the loan has been stabilized following an equity cure. For our Middle Eastern sponsor client base, release of distributions to their investors has been a key factor in re-negotiating the terms of their existing loan agreements. Having said that the practicalities of the current market has meant that in many cases there is very little (if any) cash available for distributions, even in the cases of stablised loans.

AMENDMENTS, WAIVERS AND CONSENTS

We have seen a wide range of approaches to providing borrowers with flexibility following the occurrence of an event of default or a potential event of default, including the execution of simple consent/amendment letters effecting the amendment and restatement of loan agreements, along with reconfirmation and/or re-grant of existing security. Our borrower clients have been reluctant during these difficult times to spend significant amounts of time and money on documenting the amended terms of loan agreements, with the belt and braces approach of re-granting security. This has in certain cases caused real tension with their lenders, whose desire is to protect their position during times of uncertainty. We will closely watch this space as the crisis continues to unfold with falling valuations, changes to consumer behaviors, potential downsizing of physical store footprints, potential reduction in demand for office space and most of all more strains on lenders' internal resources.

If any of these observations spark any particular interest on your side, please feel free to contact any of the K&S contacts listed in this client briefing.

ABOUT KING & SPALDING

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