REAL ESTATE FINANCE

BANKING HANDY GUIDE

BRODIES LLP

An introduction

Real estate finance (REF) is a means of putting funding in place for the purchase, development and/or operation of commercial or residential property.

The ambit of REF is wide, covering a variety of property types such as offices, shopping centres, retail and leisure, hotels, student accommodation, social housing and the private rented sector. There are different factors which will have relevance depending on the specifics of each transaction, but it is helpful to gain familiarity with a number of key points and terminology when embarking on a REF deal.

> Once a property is developed, it can then be sold, or the income stream from operating the property used to generate income.

Development/investment transactions

REF transactions are generally "investment" or "development" in nature. A development property transaction relates to the purchase (or refinance) of a property which is either completely unbuilt, or is to be refurbished or redeveloped, whereas an investment property transaction generally relates to the acquisition or refinancing of a property which is already built and operational. Once a property is developed, it can then be sold, or the income stream from operating the property used to generate income. Properties may have existing tenants in situ (this would be likely in certain investment deals such as where the property is a shopping centre or office block), and rental income from tenants can be utilised to service the loan and, depending on the financing terms, towards the repayment of equity and/or subordinated debt.

Some Key Points and Terminology

Borrower

The borrower in a REF transaction is often a special purpose vehicle, or SPV, which does not hold any assets other than those which relate to the property (including title to the property).

From a borrower's perspective, borrowing via an SPV will ensure that the lender has limited recourse to its assets on enforcement (rather than if the borrower was not an SPV and had interests in a number of assets which did not relate to the property being financed or secured). From a lender's perspective, in an enforcement scenario having an SPV borrower makes it more straightforward to step in and take over the operation of the property or, if desired, transfer the company or property.

Construction

In a development transaction, the lender would ordinarily instruct a review of construction documents and, if required, depending on the level of the debt, for security to be taken over those contracts. Specialist construction lawyers would review the building contract, professional appointments and any collateral warranties, including whether the collateral warranties are capable of being assigned in security in favour of a lender. Depending on the size of the transaction and level of debt funding a lender may appoint a project monitor to report on the development and certify that works have been carried out on the development prior to the lender permitting a drawdown of development funding.

Duty of care agreement

This document is entered into between the borrower, the lender and a managing agent or asset manager which has been appointed to manage the property, and establishes a duty of care by the managing agent or asset manager in favour of the lender. The lender can direct where monies collected by the managing agent or asset manager (for example, rents) are to be paid. The parties will also agree a contractual right of step-in for the lender in certain circumstances, giving the lender the ability to terminate the managing agent or asset manager's appointment or to direct the managing agent or asset manager to carry out certain actions. This is an additional protection for the lender as it assists in enabling the lender to take control of the property.

Financial covenants

It is usual for a REF facility agreement to include a loan to value covenant and an interest cover covenant although additional covenants or alternative covenants will apply depending on the asset class (e.g. if a hotel, the lender may require a debt service cover covenant and a leverage covenant). A loan to value covenant obliges the borrower to ensure that the loan to value ratio is maintained at (or is less than) an agreed level, and that the ratio of interest cover (i.e. that the rental income from the property will be sufficient to cover interest and any fees which are payable under the loan arrangements) is maintained at a sufficient level. The test dates for the covenants will be agreed in the facility agreement and the directors of the borrower will provide a signed certificate to the lender on the relevant test dates certifying compliance.

Forms of facility agreement

As mentioned above, properties are generally categorised as "investment" or "development". A facility agreement will be tailored to the type of property which is being financed, with different representations, undertakings and covenants applying as necessary.

Insurances

Usually a lender will require to be both composite insured and first loss payee on the borrower's policy or policies, and may also require an assignation in security over the insurances and insurance proceeds to be taken. It is usual for comprehensive insurance policies to be put in place which cover events such as fire, subsidence, and other damage to the property.

Lease documents

These can comprise both agreements for lease and occupational leases. A lender will require details of leases as part of the property due diligence and will also monitor the leases throughout the life of the loan, seeking to ensure that it can exercise control over how the leases can be dealt with (e.g. by the inclusion of provisions in the facility agreement requiring lender consent for any amendment, assignation or sublease of a lease), in order that the ongoing income stream is safeguarded.

> The lender may direct payment of the rental income into a specific blocked account which is controlled by it.

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Lenders

REF transactions can be drafted on a bilateral or syndicated basis. It is not uncommon for a single lender to advance the entire loan.

Property diligence

The borrower's solicitors usually prepare a certificate of title which examines and narrates title to the property, together with details of any leases and any ancillary points which are of relevance for a lender. The lender's lawyers will prepare an overview report which summarises the key points from the certificate, and the lender will use this as part of its decision-making process in advancing the loan.

Security

A standard security will usually be taken over the property – this is the only way that fixed security can be effectively granted over property in Scotland. The lender may also require an assignation of rental income to be taken and, in a development context, an assignation of the rights under construction documents would also be taken, which would assign the benefit of the relevant construction documents in favour of the lender. An assignation requires to be intimated to the relevant counterparty for it to be effective. The lender may also require the borrower's shareholder to enter into a share pledge which would allow the lender to step in to control and direct the actions of the borrower SPV more easily on enforcement. Under Scots law, a share pledge is perfected by the shares actually being transferred into the ownership of the lender (or a nominee company) and the register of members of the borrower company would be written up to reflect the transfer in ownership.

Registration

A standard security must be registered at Registers of Scotland. Once registered, details of the security will appear on the title sheet which gives notice to third parties that the property is subject to security. All security granted by a UK-incorporated company or LLP must be registered at Companies House within 21 days of the date of creation of the charge. Any failure to register the security will result in all sums due under the security document becoming immediately due and payable, and the security will be void as against an administrator of the company or LLP.

Rental income

If tenants are in situ at a property under a lease, the lender will require details of the amount of rental income generated (including for the purposes of the interest cover covenant calculation) and how this can be used to service the loan. The lender may direct payment of the rental income into a specific blocked account which is controlled by it.

Tenant contributions

These relate to any amount that a tenant is obliged to pay in terms of contributions to ground rent, VAT, any service charges etc. These will usually be excluded from the definition of rental income in the facility agreement for the purposes of calculating the interest cover covenant.

Valuation

The lender will obtain an independent valuation of the property in order that it can ascertain what its exposure will be and that the loan to value financial covenant is appropriate. An initial valuation will be obtained and the valuer will then review the property due diligence which has been prepared, and will confirm whether anything contained in the diligence documents will impact on the valuation. The cost of the initial valuation will usually be borne by the borrower. The facility agreement will contain provisions allowing the lender to call for updated valuations during the life of the loan so that the lender can closely monitor the property value and check that there has been no breach of the loan to value covenant.

What Brodies can do

Brodies' REF team acts for both lender and borrower clients in a number of different sectors and has extensive experience in the drafting and negotiation of bespoke real estate loan and security documents. The team works closely with specialist property, construction and planning lawyers to provide seamless, full-service advice on all aspects of REF transactions.

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