CoStar Column: A Guide to Streamlined Lender-Borrower Relations

Dean Harris, Managing Director, Credit & Asset Management - EMEA, Trimont Real Estate Advisors, Says it Looks at the Critical Ways Lender-Borrower Relations Can be Improved During Tough Economic Times

Improved reporting is a vital element of borrower-lender success (Getty Images)

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After exploding onto the world stage earlier this year, COVID-19 has forcibly galvanized change within industries that have not recently experienced significant shifts in the status quo. Commercial real estate is, in many ways, a prime example. As we move into the second half of 2020, potential long-lasting effects within the CRE industry are beginning to separate themselves from shorter-term reactionary tremors.

Whilst the global economy emerges from a state of lockdown, noticeable shifts within the CRE finance sector are piquing the interest of Investors, Borrowers, and others working in this space.

The CRE lending environment over the past seven years has been relatively benign. This post-GFC era boasted fewer covenant breaches and loan defaults than reported in previous periods due largely to increased diligence and review of finance documents early in the Lender-Borrower negotiation process. However, like the GFC, COVID-19 has upended many long-held ideas and practices leaving all players scrambling for answers. Whilst Lenders constantly review and re-underwrite their positions, Borrowers are looking to advance data deployment to inform better decision-making. This has effectually pushed the state of Borrower reporting to the forefront amongst industry insiders.

The last two Interest Period Cycles have shown a noticeable increase in Lender analysis and scrutiny regarding Borrower reporting and loan performance as it pertains to the original underwriting and business plan. Lenders have become increasingly apprehensive of late, incomplete, or inaccurate reporting and are placing greater pressure on Borrowers and their 3rd-party advisors to submit their reporting in a timely fashion. Additionally, prudent Sponsors are taking a more proactive approach to managing their relationships with Lenders; many of whom have relied heavily on those relationships during these challenging times. Timely and accurate reporting not only smooths the operation of the loan and the associated release of funds, but also builds trust between the Borrower and Lender. This creates a connection in which Lender support is more likely to be forthcoming when needed. Now more than ever, it's critical that Lenders ensure a high level of accuracy and diligence from submitted reports before releasing any surplus cash back to the Borrower through the usual waterfall of payments.

Over the past six months, there has been a noticeable uptick in the amount of reports being returned to the Borrower. Increasingly, Lenders are requesting that reports be amended due to inaccurate reflection of the terms of the finance documents. These are typical areas we most often see Borrower reports rejected or questioned by Lenders.

- When calculating projected net rental income:
    - Ensure that rent-free periods are treated correctly and whether rent can or cannot be included in calculations during the rent-free period;
    - Consider the impact of any arrears (rent and/or service charge) and the potential impact that a nominal arrears position, resulting in rent being excluded, might have on a covenant calculation;

- Understand the position concerning the treatment of Lender approved deferred rent, i.e., can deferred rent be included in calculations;
- Ensure correct treatment of break clauses (landlord, tenant and/or mutual);
- Verify correct application of backward-looking NRI or NOI, particularly during the initial post-closing period after the property has been acquired;
- Check that correct reserve account balances are being used appropriately when calculating projected interest cover/projected finance costs;
- Understand the implications of using forward-looking curves when calculating finance costs (the gradual phase-out of LIBOR will also be a consideration in future months);
- Understand the obligations of "blocked" bank accounts, particularly relating to the collection of "Net" Rental Income and what should or shouldn't be credited by the Managing Agent or Property Manager to the collection account. We often experience issues whereby Gross Rents, including AM Fees and void costs, are erroneously credited to "blocked" Accounts;

- Ensure correct calculation and treatment of void costs and non-recoverable costs;
- Be sure that hedging remains compliant with the finance documents. Take into consideration any changes to the loan that may affect the overall position. For example, loan term extensions/upsizes;
- Understand and monitor all reporting undertakings within each of the finance documents (most of the obligations are contained within the Facility Agreement, but there may be obligations in other documents, like guarantee documents);
- Ensure that insurance policies are updated to account for changes at the property. For example, properties that fall vacant or the rental income changes materially;

- Ensure that updated business plans (and renewal of business plan on an annual basis) are provided promptly and per the terms of the finance documents;

- Understand and anticipate forward-looking financial covenants, particularly if covenants, uplifts, or milestones have been negotiated in the finance documents;
- Concerning property portfolios, ensure that the appointed 3rd party asset manager fully understands the Sponsor's business plan as presented to the Lender, in respect of any asset management initiatives each property may be subject to. The asset manager should also understand what asset management actions may or may not need Lender consent;

- Check that the correct property value is being used for any loan-to-value calculation. Can any reserves be netted off from the loan balance or added back onto the valuation? Can additional CAPEX monies be accounted for in the valuation prior to practical completion of any works?

- Check that development drawdowns are being administered correctly (e.g. Borrower/Lender percentage splits) and in an agreed and timely manner. Ensure that the Lender's project monitor is informed and that any identified cost overruns are addressed and funded in line with the finance documents; and

- Monitor any additional equity injections into the structure. For example, subordinated debt.

It is important that the individual or entity assuming responsibility for the completed Borrower reporting, together with any 3rd party appointed by the Sponsor whose reports may be provided on behalf of the Sponsor to the Lender, is familiar with the negotiated terms of the finance documents. We recommend that the reporting team completes a "dry run" report as part of the pre-closing due diligence process to ensure that the finance document draft reflects all parties' understanding of the reporting and calculation requirements.

Many Borrowers have sought reporting and loan surveillance advice over the last six months. We anticipate an increase in Lender scrutiny of reporting obligations as the current cycle develops and Lenders continue to monitor their loan positions closely. Re-occurring categories where Borrowers continually seek assistance include (i) monitoring commitments to Lenders and ensuring covenant reporting is timetabled and accurate, (ii) preparing quarterly reports, (iii) loan surveillance and risk management, (iv) identifying areas of potential risk across the loan portfolio, as well as (v) day-to-day management of the Lender relationship. As we continue navigating through rough economic waters, we recommend both Lenders and Borrowers devote greater attention and resources to their Lender-Borrower interactions. Hopefully, these essential tips will help build a foundation for strengthening Lender-Borrower relations, even in such tumultuous times.

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