Finding Property Finance Solutions in a Difficult Market

Five years may have passed since the failure of Lehman Brothers ushered in the darkest days of the global financial crisis, but banking markets are still suffering from its effects and from the continuing poor conditions in the global economy. All types of financial activity have been affected by the reduced availability of bank debt in recent years.

In the following article, Raed Hanna, the Managing Director of Mutual Finance, the largest boutique financial intermediary in the U.K., considers the challenges that difficult economic conditions and lack of bank finance have presented to the Real Estate market and he gives two examples of innovative solutions that can be used overcome those challenges.

In recent years, market conditions have meant that some borrowers have – through no fault of their own – found themselves in breach of their loan covenants. This might be due to breaking a Loan-to-Value (LTV) ratio or a shift in asset values. Alternatively, the breach might arise in a debt service covenant because a tenant is having problems and then fails to pay rent. In many instances the loan taken out by the borrower is still performing, but it is nonetheless in breach of covenants, and that is a serious matter.

Mutual Finance has been working with banks and borrowers for over 20 years and has forged strong relationships built on trust, honesty, and high quality execution. As a result, the firm has been successful in working with banks to reach amicable solutions for problems facing borrowers today.

Working with banks to cure or solve covenant breaches is a "two way street" and requires a willingness by all parties to co-operate in finding a solution. Mutual Finance's "can-do" attitude has been a key factor in our ability to cut through difficulties.

There are many ways, other than a simple cash or equity injection, to resolve debt problems. The examples below show how it can be done through capital restructuring or though an interest rate swap.

Example One: capital restructuring to cure breaches of loan covenant

The client purchased a shopping mall in a strong retail

Raed Hanna, Founder and Managing Director of Mutual Finance

location in 2006, paying £120mn for the asset. Bank debt was readily available at the time and the client borrowed £100mn towards to purchase. The loan was provided with a seven-year tenor on an interest-only basis.

On revaluing the asset in 2011, it was found the value had fallen to £80mn, resulting in an LTV ratio of 125%. As a result, the loan facility covenants were breached.

Mutual Finance worked with the client and the bank to agree the following strategy:

The client produced a five year business plan showing how, with prudent asset management, the shopping mall could be improved both in terms of rental income growth and in terms of tenant profile. At a time agreeable to the bank and the client the shopping centre would be sold at a profit.

The bank agreed to provide a new five-year committed facility for £65mn. The client would inject £15mn. The bank would have to write down or "postpone" £20mn of the original facility. Any surplus income from the shopping mall would be used to amortise the bank's new facility.

With the bank facility now reduced to £65mn, the LTV ratio was reduced to 81%.

It was also agreed that the client's £15mn injection would attract 7% interest and that the following "waterfall" of payments would take effect after the sale of the shopping mall:

1. Repay bank debt of £65mn, after taking account of any amortisation.
2. Repay client's injection of £15mn.
3. Pay the interest on the client's injection.
4. Split the remaining profit of the sale 50:50 between the client and the bank.

This arrangement – and variations on it – have worked well in practice and enable both the client and the bank to recoup losses without the need to appoint a receiver and see proceeds from the sale of the asset diminished by legal and other professional fees.

Example two: "blend and extend" interest rate swap

Interest rates are a crucial factor determining the viability of a loan facility and in the years before the global financial crisis many clients arranging leveraged facilities relied on fixed interest rates to secure the highest LTV rates for their transactions.

Regardless of a client's sophistication as a property investor, their understanding of structured interest rate products is often limited, and this often leads to misunderstandings about the cost of maintaining and, if necessary, breaking interest rate agreements.

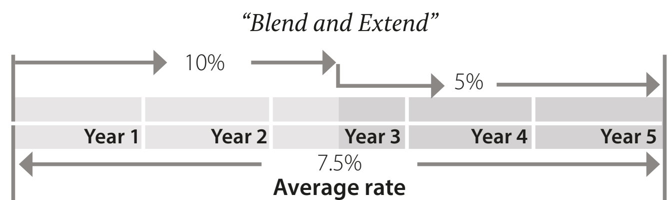
In mid-2007, a client purchased a hotel portfolio for £65mn. The financing was agreed and a £50mn five-year term facility provided for the client along with a ten-year interest rate swap priced a 5% plus margin.

In 2012, the banking facility expired and was due for repayment. Unfortunately, the client's decision to over-hedge the facility left him with a significant "break cost" that made repaying his debt by selling the asset or by refinancing the asset impossible: the hotel portfolio had fallen in value and the break cost to get out of the interest rate swap was prohibitive.

The bank agreed to provide the client with a new facility over ten years. The remaining interest rate structure (that had five years to run) was blended with the current interest rates (which were lower than the original 5% rate) to produce a new 2.85% rate plus margin.

This process is known as "blend and extend."

Mutual Finance arranged the £260mn senior debt for Standard Chartered's worldwide head office in London.



Assume that you have a mortgage priced at 10% with 2½ years to run and that current interest rates for a new five-year term are 5%. If you were to renew your mortgage today for a new five-year term, the new mortgage would extend 2½ years beyond the original maturity date. You would still suffer the 10% rate for the first 2½ years and then enjoy the lower 5% rate for the remaining 2½ years. But rather than actually charge you this, your financial institution will "blend" the two interest rates into an average rate for the 60 month term.

With a reduced interest rate on the facility the client's amortisation profile was changed to allow for more rapid repayment. There were no losses and the client regained control of the asset. There was no need to involve third parties and incur fees and other costs.

The real estate financing market is starting to recover

The banking market for real estate finance is starting to recover although lenders continue to want to secure loans on prime property, and particularly London property, and on assured and stable income. This means that there are significant elements of the property market that banks still deem "off limits", especially property that is outside London and in less attractive sectors.

The U.S. commercial mortgage backed securities (CMBS) market also offers some promising signals, with margins on AAA-rated securities now as low as 80 basis points (0.8%). The margin on equivalent securities in the U.K. is three times higher at around 250bps.

We at Mutual Finance do see light at the end of the tunnel. New lenders are coming into the market while others are returning after an absence of some years. Nonetheless, we still have some way to go before the volume of transactions returns to that seen in 2003–2007. ■

Mutual Finance is the largest boutique financial intermediary in the U.K. and is based in Old Park Lane, London. It was founded by Raed Hanna over 20 years ago. www.mutual-finance.co.uk