Covid-19 lockdown brings opportunities for those taking flexible and innovative approaches to property finance

Mutual Finance Ltd, is a London-based property firm that has financed annual transactions worth hundreds of millions of pounds. In the following article, Mutual Finance's Founder and Managing Director, Raed Hanna, explains how the Covid-19 pandemic affected the London commercial property market over the spring and summer of 2020, and he considers the industry's prospects for the months ahead.

In early 2020, we were all sitting in our offices watching the news as China seemed to be wrapped up in another epidemic that was similar to SARS and it all felt so remote and removed from us here in the UK. However, things swiftly moved on, and before we knew it Italy, then Spain and the rest of Europe, followed very quickly. In early March, I sat in our Mayfair offices and spoke to the team about the prospect of having to work from home – and even at that point the whole scenario seemed surreal and distant. Never for one moment did I expect that we would be vacating the office and the entire Mutual Finance team would be working from home for the next six months. There were some obvious teething troubles with IT and communication, but these all seemed to get resolved quickly and people adjusted to home working.

That being said, the entire real estate industry was in the same position and very quickly all offices were emptied; staff were either sent home to work or placed on furlough. The initial reaction was one of calm. The people we spoke to were all rather cautious, but at the same time positive that we would work our way through this.

But what actually happened in the marketplace?

In the lending world we saw an immediate response on all new business. This is not to say that all lenders shut up shop and stopped lending. They just took a little time to adjust to the new economic environment and decide how best to progress. There were a few banks which took some time to alter their credit policy to take on board the challenges of Covid-19. However, most lenders took a sector-by-sector view and continued to lend on more prudent terms. Typically, we saw margins increase by about 0.5% and loan-to-value (LTV) ratios reduce slightly too. One or two institutions did stop lending entirely, but this was driven by their requirement to assist existing clients and manage current loan books.

One point that should be noted is that existing business that was already agreed, with credit lines approved, was generally honoured without significant change. Lenders did all that they could to make sure that where clients had commitments to complete transactions, they were able to do so in a timely and efficient manner. For example, Citibank's hotel team completed a £340 mn deal for Constellation Hotels to finance two super-prime London assets – the Berkeley and the Connaught. So even transactions on assets that were facing the deepest slump were still being completed.

In the general commercial real estate sector, the first thing that we saw occurring was a plea from tenants to landlords to be patient and work with them to overcome their inability to pay rents. Then, of course, in turn we saw landlords turning to banks and asking the same of them. Our experience has generally been that tenants, landlords and banks have been collaborative in trying to deal with these situations. For the most part, we did not see too much of an issue with the end-March/first-quarter rental payments and overall these were paid in part or full, with agreements to deal with any shortfalls put in place. But this left us worried about what would happen at the end of June/second quarter.

June came and went, and again there was a collective approach from all parties to try to get things moving. The retail and hospitality sectors were hit the hardest and very few were able meet rental obligations in June. This, of course, creates a cascade effect where cash does not flow through the system and ultimately debt does not get serviced, whether that be interest or amortisation. Typically, we would see lenders taking a hard line with facilities in default; but government guidance to show some forbearance has created a stay of execution for a large number of facilities. The payment extensions offered and the enforced patience being shown by lenders are giving tenants and landlords time to enter dialogue and resolve the issues.

A positive example of how tenants and landlords have been working together is highlighted by our experience in the hotel sector. One of our clients owns a major central-London hotel that is let to an international hotel chain on fully repairing and insuring (FRI) lease terms. The lease had about seven-to-eight years remaining until the tenant would be able to exercise a break option. The tenant approached the landlord ahead of the end-June quarter to open a dialogue regarding a rental mortarium. Of course, the landlord saw this as an opportunity to re-negotiate the current lease terms.

In a good-spirited discussion, the landlord asked the tenant to consider removing the break option and indeed to extend

Travelodge and Whitbread, the owner of Premier Inn, have taken very different strategies in dealing with their landlords.

the lease to a 'term-certain' (that is, no possibility of change) 25 years. The tenant had no intention of leaving one of its best-performing London hotels and therefore was amenable to considering the request. Ultimately it was agreed that the lease would be extended in exchange for a six-month rental break. This meant, however, that the value of the asset increased significantly from around £150 mn to around £200 mn. Throughout this discussion, bankers were consulted and indeed were part of the decision-making process, giving their blessing and consent. The banks' overall LTV position improved meaningfully from around 70% to around 55% once the new lease was agreed.

There have, of course, been some winners in the market: we have seen banks eager to look at deals for food retailers, storage, distribution and family residential transactions in the private rented sector.

If you look at the attitude of the two leading UK hotel chains –Travelodge and Whitbread (which owns Premier Inn) – they have both taken very different strategies in dealing with their landlords. Travelodge is taking a very uncompromising approach, threatening a Corporate Voluntary Arrangement (CVA) to prevent landlords' action. On the other hand, Whitbread has been working with landlords and has turned to shareholders for support. It has successfully completed a £1 bn rights issue (which was heavily oversubscribed) which will provide the company with additional funds to weather the transition back to normality, and even expand its existing offerings. The two attitudes could not be further apart.

Our clients who are based in the residential development industry seem surprisingly upbeat at present. Although initially some building sites slowed down and estate agents were unable to provide viewings, this has now changed. We hear from our clients that they are selling new homes faster than before the lockdown and that the stamp duty holiday is boosting sales. They have also commented that the difficulties in the commercial sector are very positive for them. It would appear that a number of town-centre commercial properties and sites will now become available at a reduced price due to tenant failure. This frees up these 'brownfield' opportunities for the development of new homes.

But what is going to happen next?

I think from an economic standpoint the worst is yet to come. Inevitably there are going to be further casualties in the retail sector. Tenants are going to fail and leave landlords with vacant properties where the prospect of re-letting is bleak. Unable to meet their loan covenants and repayment obligations, landlords will struggle. Ultimately the goodwill and tolerance of the lenders will run out and we will see banks begin to take action. I do not believe this will happen in a stampede, but a gradual increase in pace and action appears unavoidable. We are not seeing any fire sales at the moment and nobody is off-loading stock or panic selling. Yields are still firm and there are plenty of buyers waiting in the wings.

Many borrowers, through no fault of their own, will experience hardship. We still do not know how long and how deep the economic downturn will be, so lenders will continue to focus on lending to resilient sectors that stand the greatest chance of surviving the ravages of this pandemic. Sadly, in the short term, it is not going to be easy for many businesses. Apart from the lucky few, most companies will be focusing on survival, not growth, and banks will back those that are likely to prevail as winners within their sector.

This of, course, means that there is an entire swathe of sectors where finance is currently either absent, difficult or reserved for the elite. At the moment, leisure, hotels and hospitality are not on the radar of any lenders. It is these businesses that are going to be under scrutiny for the foreseeable future.

But as I opened this article, I reiterate my feelings that property is a tough industry used to rolling with all types of challenges. In fact, it may well be that this unfortunate event will be an opportunity for many to work in a market that has been crowded and highly priced for the past few years.

Uncertainty creates liquidity and the chance to work in a marketplace in which distress creates willing vendors and potential buyers with cash to invest. Every property cycle and market has opportunists looking to take advantage.

I do, however, believe that this event is temporary and that we should look beyond the current situation. We will get through this and people will look back on this time with some pride as once again the property and banking industry prove how robust, diverse and competitive we can be. ■