

# Loan to Value default?

Geopolitical and macroeconomic challenges continue to press the commercial real estate market. In this finance briefing we consider the key initial steps and issues for lenders and borrowers facing a potential default of loan to value financial covenant in an investment loan agreement.

Step	Legal considerations	Practical considerations
<p></p> <p><b>1. Commission Valuation</b></p>	<p>A loan agreement will usually allow the lenders to require a valuation of a property be commissioned <i>at any time</i>, and any valuation obtained by a borrower must be shared with the lenders.</p>	<p>Valuation should be instructed to confirm the “<b>market value</b>” in accordance with RICS guidance and practice.</p> <p>Borrower’s input – does the borrower have the right to approve the choice of valuer or be consulted? Check definition in the loan agreement.</p> <p>Prior review - will the valuer provide the valuation as a draft for consideration before it is finalised?</p>
<p></p> <p><b>2. What is the LTV?</b></p>	<p>Check the detail of the financial covenant, this will usually provide that “<i>the Loan to Value does not, at any time, exceed X%</i>”</p> <p>The Loan to Value will usually be calculated as “<i>the Loans... as a percentage of the aggregate market value of the Properties (determined in accordance with the most recent Valuation of the Properties at that time)</i>”</p> <p>With a portfolio facility there may be provision for amounts held in accounts such as disposals/deposit accounts to be taken into account and deducted from the “<b>Loans</b>” in the calculation.</p>	<p>Calculations to be made by lenders and the borrower – the borrower will be required to set out amounts and calculations in a Compliance Certificate</p>
<p></p> <p><b>3. Can the LTV be remedied?</b></p>	<p>The loan agreement may contain a “<b>Cure Right</b>” pursuant to which the borrower may either:</p> <p>(a) deposit an amount into a Cure Account; or</p> <p>(b) prepay the loan,</p> <p>in each case in an amount required to ensure compliance with the LTV covenant.</p>	<p>Even where a Cure Right is available, the lenders will be monitoring and considering the potential default.</p> <p>Depending on the relationship with the borrower and subject to their credit approvals, the lenders may consider potential waivers/amendments (conditional or otherwise) or a relaxation of the LTV covenant alongside a partial repayment or cash cover deposit, outside of the Cure Right mechanism.</p>

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	<p>There will be usually be a restriction on the maximum number of times that the Cure Right may be exercised.</p>	
<p>4. <b>Where no Cure Right available</b></p>	<p>Where there are no Cure Rights available for the borrower to remedy the LTV covenant breach, an Event of Default (“EOD”) will have occurred and be continuing.</p> <p>The lenders will be cautious to preserve their rights in relation to this and will usually seek to issue a reservation of rights letter promptly, to reduce any risk that the lender may be deemed to have waived the EOD (and should also ensure their conduct is not inconsistent with their reservation of rights to avoid the suggestion they have waived the EOD).</p> <p>Depending on the scale of the potential LTV breach and the borrower’s financial condition and subject to obtaining credit approvals, the lenders may be willing to issue a waiver letter (which may have conditions attached e.g. a cash trap, a limited period for the waiver, or maybe a period of time for cure or injection of equity for breach of financial covenants or to allow for a refinancing or a voluntary sale), which should comply with requirements in the underlying finance documents (including any lenders’ consent thresholds).</p>	<p>Lenders will undertake an information gathering exercise to understand the scale of potential LTV breach and the borrower’s financial condition:</p> <ul style="list-style-type: none"> <li>- Is this an isolated breach which can be remedied relatively easily (e.g. because sponsor equity injection forthcoming)?</li> <li>- Is it thought to be a temporary blip in the CRE market affecting all properties or is it specific to this property/this borrower?</li> <li>- Are there broader issues, for example balance sheet no longer sustainable, borrower insolvent, issues with borrower’s management team or with management of secured properties by current managing agent or asset manager?</li> </ul>
<p>5. <b>Security review</b></p>	<p>Depending on the nature and extent of the LTV breach, where the lenders are anticipating potential enforcement or restructuring may be required, the lenders may instruct lawyers to review their existing security package to ensure the lenders have valid and enforceable security (e.g. registration and perfection requirements met) and to consider the enforcement routes which may be available.</p>	<p>The borrower is typically expected to cover the cost of any security review – there may be discussions over scope required at this stage.</p>

There are wider considerations when considering a LTV default for a property development financing such as the basis of the valuation and any assumptions that apply prior to Practical Completion or stabilised trading. We will look at those and the next steps for lenders considering enforcement and restructuring options in separate briefings.



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