February 2019

REAL ESTATE FINANCE UPDATE

INTRODUCTION

Welcome to the February 2019 edition of the Addleshaw Goddard Real Estate Finance Update.

In this edition at page one we take a look at the growth of the 'green finance' market, in particular the significant growth in 'green loans' that has occurred over the last year and is forecast to continue throughout 2019 and beyond. Amongst other points of discussion, we consider the drivers behind this growth, the impact of the LMA's 'Green Loan Principles' and the potential benefits to lenders and borrowers alike in entering into socially and environmentally responsible activities.

At page three we examine the new lease accounting standard IFRS 16 that applies to financial reporting periods beginning on or after 1 January 2019 by considering how the changes to the accounting treatment of leases may affect the terms of loan agreements and what action can and should be taken to commercially manage the consequences.

At page five we provide a brief summary of the key budget announcements relevant to the real estate finance market and what impact these might have in the coming months.

Finally, at page seven we set-out and review the legal concept of implied 'good faith' in commercial contracts where there is a contractual discretion, known as the 'Braganza duty', in light of the recent case of UBS AG v Rose Capital Venture Ltd and others where the High Court was asked to consider whether such a duty could and should be implied into the terms of a mortgage agreement.

We do hope these articles are of interest – do not hesitate to contact any of the team if you would like to discuss (see page nine onwards) or if there are topics which you would like us to address in future editions.

We look forward to working with you over the coming months.

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THE GROWTH OF GREEN FINANCE

Awareness of environmental issues has gathered pace in recent years and no more so than in the last few months. Following the signing of the 2015 Paris Climate Change Agreement the transition to a low carbon economy has been high on the UK Government's agenda, as demonstrated most recently in June 2018 by the launch of a new Government co-funded Green Finance Institute with the City of London Corporation to champion sustainable finance in the UK and abroad. This initiative, the establishment of working groups on sustainable finance, the publication of a number of discussion papers (e.g. the Financial Conduct Authority issued a discussion paper in October 2018 entitled 'Climate Change and Green Finance' to encourage the UK finance industry to engage with the UK's transition to a greener economy) and the issuance of voluntary principles and guidelines on green financing by industry bodies (e.g. the LMA Green Loan Principles) has contributed to the increased pressure on the finance industry generally and, due to the impact buildings can have both on the environment and the wellbeing of those utilising or in the vicinity of buildings, the real estate finance industry in particular to demonstrate environmentally sound behaviour.

So what is green finance?

'Green finance' is an umbrella term used to describe any kind of financing (whether that be bonds, equity or debt) that supports or encourages environmentally sustainable behaviour.

The green bond market has been busy for some time and is currently worth approximately $160 billion annually, consequently, it is evident that green bonds have played an important role in encouraging investment into green projects. The Green Bond Principles (GBPs) were introduced in 2014 (updated in 2017) by the International Capital Market Association as voluntary guidance for bond market participants in the issuance of green bonds. The key element of a green bond is that the proceeds will be invested into projects, activities or assets that have a specified environmental benefit. The use of the proceeds will be detailed appropriately in the legal documentation and will often be used as a marketing tool to expand the investor base for the bond issue. As detailed below, it is clear that the bond market has provided the foundations for the evolution of the green loans market.

Green loans are a relatively new development but experienced significant growth during 2018 and the indications are that this growth will continue in 2019. Until very recently there were no agreed guidelines setting out what makes a loan 'green', and parties to such a loan would often look to the GBPs for direction. However, on 21 March 2018, the LMA published its Green Loan Principles (GLPs), which build on and refer to the GBP with a view to promoting consistency across financial markets. The GLPs seek to provide a framework of voluntary recommended market guidelines and include an appendix that provide a non-exhaustive list of eligible green projects to assist the industry in identifying environmentally friendly lending, with the aim of promoting and supporting environmentally sustainable economic activity. The GLPs will be reviewed and, where necessary updated, on a regular basis to ensure that they evolve with the developing and growing global green loan market. This continual review is evident in the update that was posted to them in December 2018 to include an explanation as to how the principles can be applied to revolving credit facilities whilst maintaining the integrity of the green loan product. The publication of the GLP means that a loan that is made available for a specified green purpose, in a real estate finance context this would include ensuring or improving the energy efficiency of a new or refurbished building or the development of a building which meets regional, national or internationally recognised standards or certifications (for more detail see Appendix 1 of the GLP), can now legitimately be categorised as a 'green loan'.

In addition, beyond the scope of the GLPs and the focus on use of proceeds, the market has seen the evolution of commercial concepts and documentary mechanisms which instead of specifying that the loan must be utilised for a green purpose provides a financial incentive for the borrower to engage in environmentally responsible or 'green' behaviour. The loan documentation includes, what are being referred to in the market as, 'green' covenants that set out certain sustainability criteria (e.g. relating to CO_2 emissions, water usage, energy performance certification and/or certification that an agreed annual amount has been invested into achieving energy efficiency) that are tied to a reducing margin ratchet. Compliance with these covenants will most likely be tested by an independent party, although certification by the directors may be acceptable in some deals. The covenants are genuinely being used as an incentive and not a stick i.e. failure to meet criteria will not result in a breach or trigger an event of default. This type of 'green loan' naturally opens up the door to green financing to a much wider group of corporate borrowers than the strict use of proceeds approach supported by the GLP might otherwise do.

What are the benefits to REF lenders?

The benefits to the lender of providing any form of 'green loan' are that (i) they are associated with the sustainable financing that is being widely promoted by the Government and industry bodies to ensure a transition to a low-carbon economy; (ii) corporates that engage in sustainability and are environmentally conscious are viewed as a better credit risk; and (iii) encouraging sustainability can often result in an increase in the value of a lender's security (for example improving the energy efficiency of a real estate asset).

How can REF borrowers take advantage of this?

As is evident from the 'noise' in the market around green financing there is clearly an appetite for improved environmental performance from both lenders and borrowers. This coupled with lenders' internal corporate and social responsibility requirements means borrowers could use the opportunity to obtain beneficial pricing. Public expectation of brands acting in an environmentally conscious manner is growing, and positive sustainable behaviour is a useful selling point to both stakeholders and customers.

AG has experience advising on both green bond issuance and green loan documentation. Please do not hesitate to contact our team if you wish to discuss this further.

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IFRS 16: HOW THE CHANGES TO ACCOUNTING TREATMENT OF LEASES MAY AFFECT YOUR LOAN AGREEMENTS

What is IFRS 16 and what does it change?

IFRS 16 is the new lease accounting standard which applies to financial reporting periods beginning on or after 1st January 2019.

IFRS 16 removes the distinction between operating and finance leases. As a result, lessees will need to account for all leases on their balance sheets, including leases which would have been treated as operating leases and accounted as an expense for the purpose of its profit and loss account.

Previously, the treatment of leases under IFRS and UK GAAP depended on whether it was a Finance Lease or an Operating Lease, the distinction being the level of risk and reward transferring to the lessee (i.e. the borrower). Typically, in relation to Finance Leases, the risk and reward transferred to the lessee and the lease payments were recognised as a liability with a corresponding asset on the balance sheet. In contrast, under an Operating Lease sufficient risk and reward remained with the Lessor, and the expense was reflected on the Lessee's profit and loss account, with no impact on the balance sheet. Finance leases typically covered specialised plant and machinery or specialist assets, whereas operating leases were usually non-specialised property leases.

How might this affect loan agreements?

These changes could be material in respect of loan agreements to borrowers that have significant leased assets, such as those in the manufacturing, transport, retail and leisure sectors. So, in the real estate finance sphere in particular, thought should be given to the issues arising from the changes to IFRS 16 when providing loans to borrowers with existing operational businesses. Such borrowers are likely to experience increases of assets and liabilities on their balance sheets and a shift as to costs on their income statements. The changes may result in a positive impact on EBITDA, as operating lease payments will no longer be considered operating expenses consequently reducing EBITDA, but this is unlikely to be sufficient to off-set the increase in recorded debt. The overall result is a potential impact on all financial covenant calculations and those provisions that operate by reference to a borrower's debt. For example, in respect of loans provided pursuant to LMA based documentation the relevant definition to consider would be Financial Indebtedness and provisions that might be affected are those restricting the incurrence of debt, any negative pledge or cross-default.

What action can or should be taken?

To the extent that the changing accounting standards have not been accounted for in existing financing documentation, parties will need to consider whether any amendments are required to accommodate the changes to lease accounting treatment brought about by the new IFRS 16 and to avoid any unintended breaches of relevant loan document provisions by borrowers. This will involve a careful review of the applicable definition of 'debt' (e.g. Financial Indebtedness), any other relevant financial covenant definitions and the scope of any provisions that operate by reference to those definitions.

Some loan agreements may include a 'frozen GAAP' provision that could provide a short-term answer to any concerns. However, it is not a long term solution and can be fairly burdensome and impractical for a borrower because it involves the borrower having to prepare two sets of accounts i.e. one set in compliance with current accounting practices for the purpose of filing etc. and one set in compliance with day 1 loan agreement requirements for the purposes of demonstrating compliance with financial covenants.

If there are any concerns about potential problems arising out of the impact of IFRS 16 then parties should open a dialogue as soon as possible, if they have not already, to explore those concerns and, if required, the possible solutions. Solutions might take the form of an early refinancing or an amendment and restatement to document any necessary changes.

The LMA has included two amendments to its definition of Financial Indebtedness that it is worth considering. The first is a small technical change so that instead of referring to the indebtedness under Finance Leases the definition refers to "any lease…which would…be treated as a balance sheet liability" to ensure that all types of leases relevant for IFRS 16 are captured. The second is an optional commercial change that allows the parties to exclude from the definition of Financial Indebtedness those leases that were previously thought of as Operating Leases.

Conclusion

In respect of each individual transaction the significance of any impact of the changes brought about by IFRS 16 will of course depend on the number and scale of any leases currently in place. Given the changes have been in the pipeline for some time though, it is likely that any recent financings will have taken the changes into account in drafting of the loan documentation, and in particular the financial covenant definitions, and the base case model.

The challenge will be: (i) to the extent covenants are calculated in relation to pre-IFRS 16 principles, how will lenders accept financial ratios and statements which are determined on the basis of outdated accounting principles; and (ii) to the extent the definition of 'debt' does not reflect the new IFRS 16 position how will they deal with resulting potential breaches of other provisions such as permitted incurrence of debt? When conducting any review parties should not only think about the existing position, but look forward and consider the impact of future leasing options and how this may impact their wider financing packages.

Please do not hesitate to contact our team if you wish to discuss this further or require any support in reviewing your current financing documentation to assess the potential impact.

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IMPLICATIONS OF THE BUDGET FOR REAL ESTATE FINANCE

Amongst the histrionics and never ending noise surrounding the "B" word, there may have been some key announcements on the other "B" - the Budget - taking effect shortly which slipped under the radar. This article intends to highlight some of those key budget announcements and examine their implications for the real estate finance market.

TAX

For investors and lenders, intended changes to the tax treatment of real estate could well have an impact on risk profiles in certain sectors.

Capital Allowances

The introduction of a new form of capital allowance for the cost of works creating structures and buildings is an important change, and could signal an increase in the development of commercial real estate. The "Structures and Buildings Allowance", a new form of tax relief on eligible construction costs, will be available at a flat rate of 2% per annum over a fixed 50 year period starting from when the structure or building comes into qualifying use. The relief can be claimed on expenditure incurred on or after 29 October 2018.

It's applicable to offices and retail, warehouses and factories, and notably will include costs for new conversions or renovations. The benefit of unclaimed expenditure automatically passes to the buyer on the sale of a relevant building, but customers will need to keep records of expenditure incurred on the works (eligible for relief) and that attributable to the land, which does not qualify for the allowance. It's hoped the package will be a spur to capital investment for business.

Corporation Tax

In an unsurprising move consistent with last year's Budget, the Government is cracking down on overseas corporate landlords escaping the UK tax regime due to non-resident status. The overseas companies will now be subject to corporation tax on UK property income from 6 April 2020. While the move is clearly trying to create a more level playing field between UK resident and non-resident corporate landlords, it may result in investors questioning the Government's long term taxation strategy and whether further changes are still to come.

Capital Gains

From April 2019 overseas investors who make a capital gain on the disposal of UK property (direct disposals) or on the sale of shares in property-rich entities (indirect disposals) will become subject to capital gains tax.

For indirect disposals, if more than 75% of the gross asset value of the property-rich entity being disposed of comes from UK land, that entity will be caught. Similarly, if a non-resident held a 25% or greater interest in the property-rich entity at any point in the 2 years ending on the date of disposal, capital gains tax will be chargeable.

Again for indirect disposals there's an exclusion for land involved in a trading business, so that trading groups holding such land may not count as "property-rich" and will not be subject to the charge. So, oversees investors disposing of shares in a retailer which owns high-value shops, for example, will fall outwith the new regime. There's a risk, however, that this will be seen as a penalty on foreign investors' involvement in UK real estate, a group who have traditionally helped the market thrive.

The Government also confirmed an extension of the Real Estate Investment Trust (“REIT”) capital gains exemption on direct disposals of UK property rich entities. To coincide with the above mentioned changes in relation to foreign investment vehicles, where a UK REIT is property rich with UK assets, any gains on disposals of such entities will be excepted under the same mechanism as property disposals.

Finally, do not forget that one of the big Budget announcements of 2017 will come into effect in April 2019 – those selling commercial property will now not be allowed to use indexation to mitigate capital gains tax liability – so tax will now be due on 100% of the profit made by investors. This could impact property values and, compounded with strong UK inflation making income yields less valuable in real terms, property funds (exempt from CGT) and REITs may become much more attractive.

RETAIL

Looking to the deflated retail sector – is the outlook any better for 2019?

In short, maybe, but only for some. The Government is cutting business rates by a third for properties with a rateable value less than £51,000. Intended to "support a sustainable transformation of high streets" - this will apparently benefit up to 90% of retail properties and apply for 2 years from April 2019. There was a £675m Future High Streets Fund set aside for councils to bid for funds to turn town centres into "vibrant community hubs" by investing in transport and land assembly. It is hoped that this will help revitalise smaller high street businesses and retailers and help protect them as investment opportunities for the future.

Professional services and estate agents will not be included in the business rates relief, and the Budget was silent on help for larger occupiers who are facing the same bleak and uncertain trading future as the rest. With not enough support from the Government, then, engagement with landlords and lenders will be essential to help review and facilitate cost management of larger retailers facing significant trading challenges.

HOUSING

What the Government itself has labelled the "broken housing market" was the real focus on the property side of the Budget with the Government committing to supply an additional 300,000 new homes per year. The Housing Revenue Account cap controlling local authority borrowing for house building was abolished from 29 October 2018 in England, enabling Councils across the country to increase house building to around 10,000 houses per year in total.

There will apparently be £8.5 million available in order to allocate land for affordable housing – this could be positive news for investors looking to diversify their portfolios.

Tax breaks for home sales to long-term tenants and stamp duty relief for first-time buyers of shared ownership homes may provide a push of confidence in the housing market, reversing homeownership decline and encouraging market penetration for first-time buyers.

What next?

Regrettably the wider political uncertainty and instability was never going to be something a generous Budget announcement could fix. Creative measures may well be required in the coming months to ensure the UK remains a leading destination for real estate investment. However, where there are challenges there will be opportunities, and those with the wherewithal will be able to use this period to maximise profit from property

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THE BRAGANZA DUTY AND THE IMPLICATIONS FOR REAL ESTATE LENDING

What is the issue and why is it of interest?

Certainty of contract is one of the fundamental pillars of English contract law. It is arguably because of this focus on certainty, there is no overarching general duty of good faith in English contract law and specifically implied duties of good faith have, to date, otherwise been relatively rare, particularly in freely negotiated commercial contracts.

Recently however the courts have been more willing to accept the construction of implied terms into commercial contracts, including financing arrangements, which were not expressly contemplated by the drafting agreed between the parties. One such term is an implied duty of good faith (otherwise known as the Braganza duty) the implications of which we seek to highlight in this update.

Ultimately this duty means that counterparties need to pay greater care in the drafting of financing arrangements. Where possible, powers should be framed as narrowly defined contractual rights as opposed to broader contractual discretions, to reduce the likelihood of a duty of good faith subsequently being implied by the courts. Even where the drafting has been narrowly construed as a contractual right, care should still be taken in the exercise of those rights as the courts may nonetheless be willing to imply that such rights must be exercised for "legitimate commercial aims" and not to vex the other party.

What is the Braganza duty?

The case of Braganza v BP Shipping Ltd established the principle that if a contract gives a party a discretion in a matter that affects the other's interests the courts may imply a duty that the discretion must be exercised in good faith and not arbitrarily, capriciously or unreasonably (the "Braganza duty").

In imposing an implied duty of good faith, the courts have generally only deemed it appropriate to do so in respect of "contractual discretions" which can be described as making an assessment or choosing from a range of options, taking into account the interests of both parties as opposed to a simple decision whether or not to exercise an absolute contractual right, such as making a decision to call for a valuation of a property. However, the distinction between the two is fine and caution should be exercised in assuming that a duty of good faith would not be implied based purely on a view that a provision is a contractual right and not a discretion.

What was decided in UBS AG v Rose Capital Venture Ltd?

A more recent case, which has direct implications for real estate lending was UBS AG v Rose Capital Venture Ltd and others, which involved a mortgage agreement between a claimant lender and the first defendant. Unlike Braganza, the High Court did not imply a duty of good faith in demanding repayment of a loan because the drafting made it clear the loan was made on an uncommitted basis, was repayable on demand and entitled the lender to call for repayment of the loan at its 'absolute discretion'.

What are the practical implications for real estate lending?

It is thought by some commentators that the implications of Braganza and related cases are likely to be of limited import in a lending context between sophisticated and well advised counterparties but this does not mean the risk of being held to an implied duty of good faith or any other implied duty should be ignored. What is clear is that the courts are driven by the factual circumstances of each individual case and, as always, the specific drafting of the agreement in question.

Factors likely to increase the risk of a duty of good faith being implied include a transaction being in a regulated sector or a clear inequality of bargaining power between the parties.

In practice, the rights and powers in a lending transaction are commonly drafted to be subject to determination in a lender's "absolute discretion" or qualified by "acting reasonably".

Where an express obligation to "act reasonably" in the exercise of a power is imposed, it is generally accepted that the lender only has to act, from an objective standpoint, in a reasonable manner having regard to their own commercial interests and not those of the borrower.

Where the manner in which a contractual right is to be exercised unqualified a lender may come to the conclusion that it can exercise that right in such manner as it sees fit, subject to the general principal that no person may benefit from their own wrongdoing. However, even where the lender is exercising a contractual right (for example, the usual right that real estate lenders have to call for an updated valuation of a property post-default) in the case of Property Alliance Group Ltd v RBS plc whilst not being subject to an implied duty of good faith, the court concluded that such right ought to be "exercised in pursuit of legitimate commercial aims" rather than to maliciously vex a counterparty.

In general, loan documentation will (or at least should) try to allocate contractual rights to the finance parties, to make a decision for their benefit (or protection) and is less likely to allocate broad contractual discretions, such as determining a person's cause of death (Braganza) or, in a property context, the reason why a property was destroyed or damaged. Even so, drafting should be approached carefully to ensure the conditions for exercising contractual rights or powers are as clear as possible, ideally avoiding broader contractual discretions where a duty of good faith may be more likely to be implied. Notwithstanding that rights or powers may have been drafted as narrow contractual rights, we have seen that the courts are nonetheless willing to imply that certain rights must, if not in good faith, at least be exercised in the pursuit of legitimate commercial aims.

This is a developing area of case law and parties should not assume that the insertion of words such as "sole discretion" or "absolute discretion" will circumvent the imposition of an implied duty of good faith or an implied obligation to exercise a right in the pursuit of legitimate commercial aims. The broader the right or discretion the greater the risk of a duty being implied, so clear and careful drafting remains key.

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