**KEY POINTS**
- Financial covenants continue to be a key feature of real estate, development and project financings with an increased focus from lenders and borrowers on the component parts of the various ratios.
- The precise wording of each financial covenant definition (including carve-outs and assumptions) can be critical in determining whether financial covenants are met when they are tested.
- Notwithstanding the safeguards provided by financial covenants, lenders are often keen to ensure that earlier warning triggers are included in the form of cash trap covenants, and borrowers will often seek to include equity cure rights to offer breathing space.

Feature

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# Arc of the (financial) covenant: issues for project and real estate finance

Since 2015, there has been a rising tide of "cov-lite" leveraged loans issued in Europe which do not contain maintenance financial covenants that, if included, would be tested on a quarterly or semi-annual basis. This trend has continued despite the onset of pandemic-related lockdown. In many cases, private equity borrowers have negotiated short-term waivers in relation to the requirement to test "springing" leverage financial covenants which would normally be tested for the benefit of revolving facility lenders when the relevant facility is drawn.

Outside of the leveraged finance market however, financial covenants remain a key feature of a wide range of loan financings. This article discusses the financial covenant packages used on project financings, and on real estate and development financings, together with some of the common structuring and negotiation points that arise.

## PROJECT FINANCE

The traditional project finance model involves using long-term contracted cashflows to repay loan facilities used to (re)finance the construction of the relevant asset (such as a renewable energy plant or a public-private partnership asset). Therefore, the financial covenant package generally consists of:

- a Debt Service Cover covenant which tests the cashflows of the borrower (generally a special purpose vehicle) against its debt service obligations (interest payments and fees) over the relevant testing period and therefore its ability to service its amortising loan facilities (cashflow is used rather than EBITDA given the borrower will generally be a special purpose vehicle company with a single revenue stream which will be used to service the financing, such that this is the most appropriate metric to test rather than EBITDA which would incorporate "non-cash" accounting measures such as depreciation of fixed assets); and
- a Loan Life Cover covenant which tests the ratio of the net present value of forecast "net cash flow" (being project revenues after deducting taxes, operating expenses, capital expenditure and other expenses) over the remainder of the tenor of the financing to the outstanding principal amount of all loans as at the relevant testing date. Therefore, the Loan Life Cover covenant also measures cashflows against debt service, but is over the unexpired life of the project rather than solely over the relevant testing period. Loan Life Cover covenants are not included in all project finance transactions and may instead be used as a lock-up ratio which must be satisfied as a condition to the borrower making a distribution to its shareholders.

### Forward and backward-looking financial covenants and lock-ups

Traditionally, project finance transactions included both a historic or "backward-looking" Debt Service Cover covenant (tested in relation to the relevant six or twelve month period ending on the testing date) and a forecast or "forward-looking" Debt Service Cover covenant (tested in relation to forecast cash flows and debt service for the relevant six or twelve month period starting on the testing date). However, it is common to see historic Debt Service Cover covenants only, with the relevant default ratio set at a level such as 1.05:1, often with a lock-up ratio (which is required to be met to permit the borrower to pay dividends) set at a higher level such as 1.10:1.

The Debt Service Cover ratio should allow for some element of underperformance against the projected performance that is set out in the financial model agreed between the borrower and arrangers or lenders at the outset of the transaction. For example, repayment profiles are often sculpted to show a minimum projected Debt Service Cover ratio of 1.20:1 for each testing period over the term of a project financing to allow for the occurrence of unexpected events or delays.

### Interaction with other aspects of financings and equity cures

The formulation of Debt Service Cover covenants may interact with other aspects of project finance facilities agreements. For example, borrowers are increasingly using debt service reserve facilities as an alternative to funding debt service reserve accounts to address the borrower's inability to meet debt service from cashflows. Where a debt service reserve facility is used, borrowers will often argue that the cost of repaying any drawn loans under that facility should not be included in "debt service" for the purpose of calculating the Debt Service Cover covenant. This is to avoid a situation whereby drawing down a debt service reserve facility could reduce the Debt Service Cover ratio on future testing dates by increasing "debt service".

Parties may negotiate how any equity cure mechanics interact with the use of a debt service reserve facility, given that such a facility can generally only be used to address a temporary cashflow shortfall rather than to address any breach of the Debt Service Cover "default ratio". Borrowers will seek to ensure that the undrawn amount of any debt service reserve account or debt service reserve facility is added to the net present value of forecast cashflow for the purpose of calculating the Loan Life Cover ratio, given these amounts should be available to fund debt service (subject to any drawstops on the borrower's ability to draw the debt service reserve facility).

Debt Service Cover and Loan Life Cover ratios may vary depending on the nature of the borrower's cashflows. Where the tenor of a financing for a renewable energy generation asset extends beyond the expiry of the relevant subsidy scheme, lenders may insist on a higher Debt Service Cover or Loan Life Cover covenant "lock-up ratio" during that merchant "tail" period to reflect the fact that the borrower's cashflows are likely to be more exposed to market fluctuations in energy prices.

## REAL ESTATE AND DEVELOPMENT FINANCE

In the context of real estate and development finance, financial covenants provide early warning signs of a potential risk to either:

- the underlying income from the property used to service the debt; or
- the economic health of the borrower or its asset value relative to the debt.

The individual components of any definition used in a financial covenant will usually be determinative when testing the ratio. In light of that, we examine those individual components in detail below.

### Loan to [Development] Value

While the Loan to [Development] Value covenant is undoubtedly the most frequently used risk metric in real estate facilities, the precise details of that covenant can differ from facility to facility.

On the "Loan" side, the following points should be considered:

- Where there are multiple utilisations (for example, in a development finance facility) should the "Loan" component just include the drawn amounts or should it also include any undrawn amounts (so as to test the position assuming that all such utilisations have been made, giving a "total commitments to value" covenant)?
- What, if any, deductions should be permitted when calculating the "Loan" component? Borrowers frequently request that any amounts sitting in a lender-blocked account (such as a deposit account, a disposals account, a cure account or a cash trap account) should be deducted from the "Loan" component on the basis that they could be applied against the drawn amounts. When considering a request of this nature, lenders and their advisers should give thought to the precise source(s) of those amounts and whether those amounts are to be applied towards a specific purpose. For example, there may be insurance prepayment proceeds in the relevant deposit account which are to be applied in reinstatement of a property and, as a result, would never be available to be applied in prepayment of drawn amounts. It would be inappropriate to allow an amount equal to those proceeds to be deducted from the "Loan" component of the covenant. A lender may often address this concern by only allowing amounts in those *accounts which are to be applied in prepayment of drawn amounts* to be deducted from the "Loan" component of the covenant. Further protection may be obtained by putting a timeframe around when such amounts must be applied in prepayment if they are to be permitted as a deduction from the "Loan" component, for example by providing that only amounts which are required to be applied in prepayment of drawn loans on or before the next interest payment date may be deducted.

In respect of the "Value" component of the Loan-to- [Development] Value covenant, while it is usually less heavily negotiated, consideration should be given to the following points:

- Who can choose the valuer that will provide the valuation? Will this be solely at the discretion of the lender or agent, or will the borrower expect to provide a list of permitted valuers or expect a consultation right?
- Should any assumptions apply to the valuation? For example, should it be assumed that practical completion has occurred? Should it be assumed that stabilisation has occurred (this may be based on a minimum occupancy percentage rate (often at least 80%) and may also require that certain financial covenants be satisfied)? Should it be assumed that a minimum occupancy (often split between residential and commercial for mixed-use developments) has been achieved? Ultimately, the assumptions will depend on how the lenders are documenting the ratios as part of their asset management process but it is important that the drafting reflects the commercial intention.
- When can a lender call for a valuation and, if a borrower independently calls a valuation, will it be obliged to deliver a copy of that valuation to the lender? Linked to this is the need to include language which makes clear which valuation will be used as the basis for any financial covenant testing – must it be a valuation approved or instructed by the lender?

### Loan to Cost covenant

A Loan to Cost covenant is commonly used in development financings. This is because the ultimate value of the development will not be the same as its value immediately after practical completion and therefore assumptions must be made when calculating the Loan to [Development] Value. Therefore, lenders often prefer to test the amount of the facility (drawn and undrawn) against the total budgeted costs (as determined by the project monitor). The components of this Loan to Cost covenant are not subject to the same level of assumptions as is the

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case with the Loan to [Development] Value covenant (although the project monitor must still project the budgeted costs based on the information provided by the borrower). When calculating the Loan to Cost covenant, the points noted above in respect of calculating the "Loan" component of the Loan to [Development] Value covenant apply equally when considering the "Loan" component of the Loan to Cost covenant. The definition of "Budgeted Costs" is the "Cost" component of this covenant. Usually the costs will be determined by reference to a budget approved by the lenders as a condition precedent to drawing the facility but it is important to consider whether the finance costs associated with the development should be considered in this definition and whether cost overruns or contingency amounts should also be included.

It is in the borrower's interest to increase the "Costs" component of this covenant, but lenders will usually resist allowing cost overruns to be included on the basis that cost overruns should be avoided, are (in theory) uncapped, and the borrower is unlikely to be permitted to use the loan proceeds to fund cost overruns. However, borrowers and lenders will commonly agree to allow contingency amounts to be included in the "Budgeted Costs" as these will usually be a set percentage of the Budgeted Costs approved by the lenders as a condition precedent and the loan proceeds may, subject to the lenders' consent, be used to fund contingency amounts. The approach taken will depend on the commercial agreement reached by the parties but will require a detailed understanding of what line items are covered by the "Budgeted Costs" so as to ensure there is no mismatch between the operation of the Loan to Cost covenant and the commercial agreement on what is being tested.

## Interest Cover covenants and Debt Service Cover covenants

Both the Interest Cover and Debt Service Cover covenants assist lenders in determining whether the underlying asset is producing sufficient income to discharge the interest and other finance costs payable by the borrower throughout the course of the loan. Lenders will want visibility over the income being produced by the asset that they have financed and, in the context of real estate finance, this will usually be the *net* rental income received by the borrower on a regular basis (ie the lenders will ignore any amounts that the borrower receives from tenants where those amounts are allocated to managing the property (such as service charges) and are not regular income payable under the terms of a binding lease).

Lenders will want to ensure that these covenants are stress-tested as much as possible to ensure that the income side of the ratio accurately reflects the amounts which will actually be received by the borrower and that the finance costs/debt service side of the ratio takes account of all potential interest and/or other finance costs which must be discharged by the borrower.

There are a number of points to consider in relation to these two covenants:

- **Calculation period:** At the outset it is important to understand if the relevant covenant is "backward-looking", "forward-looking" or a hybrid of both. In the definition of "passing rental", a number of assumptions may be included (as discussed further below) but careful consideration should be given to whether it is appropriate to apply any assumptions to a "backward-looking" calculation, or whether "actual" income received should be included. Where lenders have agreed a waiver period during which a "backward-looking" covenant is not tested, the parties may then need to adjust the calculation period for the first test date following the waiver period. The borrower will naturally seek to shorten the calculation period to avoid taking account of income and finance costs during the waiver period despite the covenant tests no longer being waived.
- **Finance costs:** If the covenant is a strict Interest-Only Cover covenant then the parties will simply take account of the interest payable by the borrower on each interest payment date. However, if the intention is to have a Debt Service Cover covenant then particular attention should be given to the items which fall within the definition of "finance costs". For example, the suggested LMA drafting refers to "the aggregate amount [of interest [and periodic fees]] payable to the Finance Parties under this Agreement", whereas it may be preferable to expressly refer to each of the periodic fees intended to be captured (for example, commitment fees, arrangement fees or agency fees). A notable limitation is that the suggested LMA drafting refers to fees payable under "this Agreement" and this may need amendment if amounts documented elsewhere (such as under side agreements) need to be captured.
- **Rental income/passing rental:** There can often be extensive negotiation in respect of the precise amounts which should qualify as "rental income" for the purpose of any Interest Cover covenant or Debt Service Cover covenant. Lenders are generally keen to ensure that the various assumptions applied result in only those amounts which are actually received (or, in the context of "forward-looking" covenants, are likely to be actually received) being included in the relevant definition (for example, passing rental/net rental income) for the purpose of testing the relevant Interest Cover or Debt Service Cover covenant. Although it is impossible to cover all scenarios, it is worth both parties considering the following:
  - The treatment of rent-free periods, rent reviews, lease breaks, tenant insolvency (noting that there may be a different approach where rental guarantees are in place) and amounts paid by tenants which are retained as service charges (ie tenant contributions).
  - The treatment of non-"traditional" rental income such as car-park income, advertising income, concession income (for example, from stalls in shopping centres) and cyclical income (for example, student housing). If the underlying asset is an operating business such as a hotel, further thought will need to be given to what constitutes "operating income" and

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"operating expenses" and additional covenants may be needed to cater for the operating nature of the asset.
- In certain circumstances borrowers may be required to hold interest reserve amounts in a blocked account which can be used to service finance costs in a scenario where there is a shortfall. Borrowers may seek to allow such interest reserve amounts to be deemed "rental income" as the interest reserve amounts are available to service finance costs. Lenders will, however, generally only permit income from the asset itself to be considered in such calculation.

## Cash traps

Cash trap mechanics have become a common protection for lenders on real estate financings. They operate not only as an earlier warning trigger than the corresponding financial covenant, but also serve to retain income in a potentially deteriorating scenario. A cash trap event occurs where the borrower fails to satisfy certain financial covenants levels and means that any surplus cash (following completion of the rent/debt service account waterfall) which would otherwise have been transferred to the borrower's unblocked general account will instead be trapped in a blocked account. In addition to carefully setting the appropriate cash trap levels, lenders should consider whether borrowers should be immediately required to apply cash trap amounts in prepayment of loans or if the lenders should be permitted to sweep those cash trap amounts into a blocked deposit account. In the latter scenario, the following two points will need to be considered:

- The appropriate point at which those cash trap amounts should be applied in mandatory prepayment of the loans or released from the blocked account. Usually the lenders will require evidence that the asset or income has stabilised and satisfaction of the applicable covenant for two consecutive interest periods prior to permitting a release of the cash trap amounts.
- In a scenario where the cash trap amounts are being released, whether it is appropriate for such amounts to be released into a borrower-controlled general account or whether those amounts should be transferred to the rent/debt service account to be applied in accordance with the waterfall again and possibly catch-up on payments that have been missed on previous interest payment dates as they ranked behind the cash trap amounts (for example, operating expenses and asset management fees).

## Cure rights

The inclusion of equity cure rights in any facility agreement can offer borrowers a lifeline during unforeseen circumstances by allowing the injection of cash from a shareholder by way of equity or subordinated loan into the borrower for the purpose of curing a financial covenant breach. The precise terms of any cure right are usually heavily negotiated. In particular, lenders and borrowers will be focused on what the cure amount should represent in the context of testing the financial covenants. The more common position in real estate financings is that the cure amount is deemed to reduce the amount of the loan when testing any of the covenants noted above. However, borrowers may seek to have the cure amount deemed as "income" for the purpose of the Interest Cover or Debt Service Cover covenants – this is particularly borrower-friendly as it results in significantly less equity being required to cure the applicable covenant breach.

Borrowers and lenders will also need to agree if the borrower may exercise the cure right by either:

- depositing the cure amount into a deposit account (with a test subsequently applied for the release or mandatory prepayment of that amount); or
- immediately applying the cure amount in mandatory prepayment of the loans,

or alternatively if the lender will require that the cure amount be applied only in mandatory prepayment of the loans.

If there is an option to deposit the cure amount into a blocked account, the parties will need to agree the test as to when such amounts may be released to the borrower or applied in prepayment of the loans. Similar to the cash trap test, a commonly agreed position is that the borrower must be in compliance with the relevant covenant for two consecutive interest periods to permit the funds to be released. It is important to exclude the amounts deposited in the cure account for the purposes of testing the release covenant.

Ultimately, save for unexpected events, lenders will expect borrowers and their assets to perform at a level comfortably above the cash trap level for the term of any loan and so will restrict the aggregate number of times a borrower may utilise the cure rights and will also include a limit on the number of consecutive cure rights permitted. This is to ensure that a borrower is not artificially propping-up the health of the asset and/or the borrower itself and using the cure rights to mask continuing under-performance.

## CONCLUSION

Financial covenants continue to play a significant role as both early warning triggers and default tests in project finance and real estate and development finance. Despite there being quite a settled position as to the types of financial covenants that are used, borrowers and lenders should continue to focus their attention on the precise components of such covenants and ensure that any necessary assumptions as to testing mechanics and modification of standard definitions used are addressed in the drafting. In addition to ensuring they have sufficiently managed the precise terms of the covenants, borrowers should seek to ensure they have sufficient headroom in the covenant levels and consider the inclusion of cure rights which can operate as a lifeline in challenging times. ■

*Further Reading:*

- Financial Covenants (2007) 2 JIBFL 115.
- COVID-19 and the impact on financial covenants (2020) 5 JIBFL 337.
- LexisPSL: Banking & Finance: Practice Note: Leveraged finance – financial covenants.