Loan refinancing post pandemic...... plan ahead!!

by Paul Cunningham

The alternate lending market for business borrowers in Ireland has expanded considerably since 2016. Over the past 5 years, new entrants have emerged both in terms of physical office presence as well as virtual offerings across different asset classes but primarily focused on real-estate backed security, be that residential investment assets (BTL, or buy-to-let) and/or commercial real estate (CRE).

This has also extended into some SME trading asset classes typically Hospitality, Leisure, Multi-storey car parks and private Nursing Care. Because many of these lenders are unregulated, it is difficult to extract accurate data as to the extent of their current loan books. An educated guess would be somewhere north of €2bn which is about 7-8% of the reported non-Consumer books of the regulated banks from Central Bank returns.

The typical profile of the underlying commercial loan is €1m-€5m, average term of 4 years, interest rate north of 5% per annum, penalties or 'make-whole' provisions for early repayment and with the primary exit mechanism typically reliant on a refinance of the loan upon maturity.

The significant restrictions caused by Covid-19 both on SME and commercial property borrowers as well as lenders, will have consequentially led to a deferral of many loan maturity timeframes as well as some elements of forbearance on debt servicing capabilities. All of this in turn will apply further pressure and challenges on the borrowers to effect refinancing exits post pandemic. It is likely a significant number and value of such loans will contractually mature in 2022. With the market exits of both Ulster Bank and KBC Ireland, the refinancing options available have become more restrictive. In the face of such challenges, what should the borrowers and their advisors be considering to mitigate some of these risks.

Refinancing Plans

Firstly, the borrower should prepare a refinancing plan well ahead of the final maturity date. If the existing lender is not in a position to renew the loan facilities on acceptable terms, the process for seeking a refinancing partner should commence no later than 6 months from the planned maturity date. It can take up to 6 months from loan application to completion of loan security to effect a refinance even for relatively straightforward transactions. In my experiences over 20 years in both assisting the preparation of funding proposals as well as evaluating such proposals, there is a general consensus among lenders that the better and the more complete the information and data provided to the Lender, the better the prospects of having the loan application supported, subject to prevailing risk policies in place.

So, what should be on the checklist as part of the refinancing plan submission to the lenders? This can be summarised down to the 4 C's acronym– Customer, Cash-flow, Covenants and Collateral:

- **Customer (borrower) –** define the customer, the characteristics and USP of the business and its capacity and competence to manage the

assets and deliver the financial performance for sustained profitability.

- **Cash-flow –** the sanity test. How much cash-flow is being generated on a sustainable basis from underlying operations to service and repay the loan required. For SMEs, this will be a derivative of EBITDA (Free cash-flow for debt servicing) after allowing for changes in normalised working capital, payment of taxes and essential capex. Typically, there are a few key metrics the Lenders will expect to see here to satisfy their own credit risk parameters – for Property investment assets, the Alternative Lender will want 'senior debt' to provide Debt Service Cover at min 1.25 x times, the Pillar banks will typically look for a minimum of 1.5/1.75x times cover. For SME loans, the DSCRs will be similar and Debt/EBITDA ceiling levels of 3-4 x times max depending on the business sector. This exercise will largely be evaluated against audited or filed financial statements, projections for future years and review of bank statements. The Lender will also examine what level of Principal if any has been paid down to date on the existing loans, if these payments were compliant to terms of the loan and if not then a logical business explanation to support this.

- **Covenants –** depending on the underlying business and asset class, the ultimate loan agreement forming the contractual relationship with the Borrower will contain both financial and non-financial covenants. These should be examined to ensure they are appropriate for the nature of the business, can be tested periodically and are set at levels to allow for sufficient headroom relative to the base case run-rate of the business. Typically, the financial covenants will have quantitative metrics such as min Interest Cover and Debt Service cover ratios as well as Loan to Value ratio against the underlying mortgaged asset value. Non-financial covenants will tend to concentrate on the availability and frequency of reliable management information about the performance of the business to allow the Lender track current year and future year's relative to prior years and budgets or projections.

- **Collateral –** the Lender will be seeking a first legal charge or mortgage over real estate assets if available, be it on behalf of a Company through a Debenture or a mortgage on behalf of a sole trader or partnership. The net realisable value of the asset, the ease of access to the asset, the location and title to the asset will all form part of the commercial and legal due diligence. Because the legal system in effecting good title is still largely paper-based, allow sufficient time for security and title issues to be completed between the lawyers.

  Additional collateral will largely depend on the perceived and evaluated risk profile and may include Lenders seeking corporate or personal guarantees. Typically, non-bank Lenders will want to ring-fence the transaction into a special purpose company (SPC) without recourse to the shareholders personally. This may not always be the case and care and advice should be taken accordingly.

The Loan Agreement

Once the refinancing plan and the relevant and detailed supporting financial information is ready and sense-checked, this can then be submitted to the various relevant Lenders in the marketplace.

The lenders will engage with the borrower and advisors to carry out further due diligence on the proposal and determine whether they have an appetite to progress the refinance. This should be known to the Borrower within 7-10 working days of submission. Thereafter, depending on the lender's internal processes, some may issue a Heads of Terms (HOT) outlining their parameters for providing loan support, which will be subject to formal credit approval. In most cases the Lender will require the Borrower to accept the HOT sheet by signing same and in some cases, paying an acceptance fee as part of the overall cost of the loan.

Upon formal credit approval, a loan agreement will be issued as the formal Finance Contract between Borrower and Lender. This could be a short-form agreement (6-10 pages) or an LMA agreement for larger value transactions (> €10m) up to 140 pages.

Timeframe

A slow no is not in anyone's interest so maintaining contact with the Lender(s) is important. If there is an appetite to progress, the HOT sheet can be issued within 7-10 working days, in some instances sooner than this. A further 7-10 days should be anticipated for formalising a credit approval and getting a first draft loan agreement.

So typically, up to 20 business days to get from application to formal sanction. Beyond that, the timeframe to drawdown will depend on the nature of the security, the quality of the title and the efficiency of the legal advisors for both the Borrower and the Lender. If the loan is below €1.5m, the Lender may complete by way of a certificate of good and marketable title on the primary property asset. This can speed matters up. If the loan is above €1.5m then a full investigation of title is likely required which will take longer. For a refinancing, there is some comfort taken in that title will have been investigated or certified previously. Nonetheless, the slowest part of the transaction will be the completion of the legals and attendance to whatever Conditions Precedent remain outstanding such as Insurance, up to date valuation, management accounts etc.
Allow for up to 90 days for the legals to be ready to complete to allow requisition for drawdown of the loan. That therefore totals a minimum of 4 months.

The Costs

Budget for the fully-loaded costs involved in any funding or refinancing proposal particularly those costs that require a cash-flow outlay as part of or even prior to drawdown of any loan refinance. The list is not exhaustive, but I have headlined what I think will be the primary items:

- The interest coupon on the loan. The lowest cost providers for senior debt will tend to be the Pillar banks and depending on the asset class and the risk profile, this will range from 2.5%-4.5% pa over a committed term up to 7 years.

  For non-bank Lenders, budget for an interest rate range of 5.5%-7% pa for up to 5 years committed. For Bridging loans, the boutique Lenders in this space will typically seek a coupon of 12-16% pa for 12-18 months period.

- The arrangement fee will range from 0.5%-1% for senior debt and up to 2% for Bridging. Half of this is likely to be required upfront prior to formal credit sanction. It is important to negotiate that this is refunded in the event the loan is not approved.
- In some cases, there will be an exit fee ranging from 0.5%-1% on repayment of the loan.
- Most if not all of the non-bank Lenders will have a 'make-whole' provision, essentially an early repayment penalty which will ratchet down as time elapses. This can be a substantial cost and therefore should be fully understood.
- Legal fees and outlay for the Borrower and for the Lender. The Lender's legal fees should be agreed in advance to allow for cash-flow budgeting, but 0.5% of the loan plus VAT would be a reasonable guide. Borrower's own lawyers will add to this, budget say 0.3% so 0.75%-1% in total legal fees relative to value of the loan.
- Valuation fees for the mortgaged assets being made available as security. The instructions for the revaluation will come from the Lender but the cost will need to be picked up by the Borrower. Borrower should seek to get the report addressed to both Lender and Borrower and invoiced to the Lender to at least allow for recovery of the VAT.
- Intermediary fees such as Finance Broker will typically range up to 1% for senior debt plus vat.
- Other due diligence reports such as QS, Engineer, Architect, Tax Advisors as required.

A refinance for example of a €5m CRE loan out with the benefits of possibly achieving a better nominal rate of interest, could cost the following in terms of cash-flow outlay:

- Loan fee 0.5% say €25,000
- Legal fees Lender €25,000
- Legal fees Borrower €15,000
- Valuation updates, say €5,000
- Broker fee say €10,000
- Total cash cost pre-Interest €80,000 or 1.6% of the loan

Finding the appropriate refinancing Lending partner therefore becomes significant even to recover the one-off costs involved, so the term of the loan and the price of the loan by way of interest rate (relative to existing rate) should be scrutinised carefully to consider the whole of life costs associated with the refinance exercise. This is the quantitative element.

Similarly, the qualitative issues should likewise be borne in mind, such as who will be the most compatible Lending partner for the duration of the refinancing period. Do they have the range of products and services your business may require for ongoing support? Are they appropriately funded going forward? How might they react to changes in the business climate over the term of the contract?
This is all food for thought!

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