NELSON MULLINS

Real Estate Finance: Holdbacks in a Post COVID Environment

By: Ginger Rolfes

Today's post COVID environment has commercial real estate owners, investors and lenders reaching for their crystal balls. Rising sales prices for assets, capitalization rate compression, rising interest rates and a recession on the horizon – how does a property owner or lender adequately protect itself in financing for the bumpy few years to come?

Undoubtedly, there will be disconnects in pricing and structure for acquisitions and refinances. One potential loan structuring device to consider is the implementation of a loan holdback. A holdback (also referred to as an earnout) in commercial real estate finance is a provision that puts aside (or reserves) a certain portion of loan proceeds until an objective has been accomplished. Typically, holdbacks are used for an issue that is not resolved or settled prior to closing but can be resolved soon thereafter.

We are most accustomed to seeing loan holdbacks when new office or retail tenants have executed a lease but are not occupying the leased premises and paying rent prior to the loan closing. In this common scenario, lenders will reserve approximately 125% of any outstanding property owner obligations like tenant improvement reimbursements or incentive rents. After the new tenant is safely settled in its space and paying full rent, the funds which were held back by the lender are released to the property owner.

Performance-based holdbacks are less typical but can be an effective method of structuring loan proceeds when a lender and borrower have differing opinions on the valuation of a property or projection of income. A property owner may expect their site to have a higher cash flow and may want increased loan proceeds based on their projections, but the lender may be constrained by more conservative underwriting or limitations due to current market conditions. In office properties, lease provisions that provide future contraction rights are caution flags for lenders given the move to hybrid work environments during COVID but a property owner may see a tenant that is dedicated to in-person collaboration (particularly when those employees see office face time as a way to solidify their positions in the potential layoffs of a looming recession). For retail properties, sluggish sales due in part to higher prices and consumers tightening their purse strings in anticipation of recessionary struggles are a valuation challenge. For those property owners that are confident that their projection of their asset's valuation and income is on the mark, performance holdbacks can allow for the potential of increased proceeds without the additional cost, expense and time of a future advance loan structure or full-fledged refinance.

With a performance holdback, loan proceeds equal to approximately the difference in loan proceeds that would have been released if certain metrics were hit prior to closing are placed in a reserve. Over a short period of time (typically 6 to 24 months), the borrower is given the opportunity to provide evidence that the site has achieved a certain targeted debt yield or debt service coverage ratio to have those holdback funds released. It is crucial that the lender and borrower cooperatively structure release mechanisms that are clear and that the calculation methodology for debt yield and debt service ratio are accurately reflected in the loan documents – who can request the release, what documentation must be provided to substantiate the calculations, what income is credited and what expenses are deducted from the net

operating income – are all important business terms to clarify. The property owner should also consider what happens to the performance holdback funds if the property owner's fortune-telling is off the mark and the property does not satisfy the requirements for the release of funds. While negotiating the loan, borrowers should establish a realistic time frame in which to qualify for release of the performance holdback and, if the property has not performed by such time, a non-discretionary paydown of principal with a recasting of the amortization schedule after the partial paydown of the loan should be incorporated. Ideally, the paydown should be made without prepayment penalty (i.e. no yield maintenance or required defeasance) with any fees and expenses being backed out of the funds so that the property owner is not required to come out of pocket for the application of holdback funds to prepayment of principal.

Property owners should take careful stock of the potential downside of performance holdbacks, including the sunken cost of paying interest on loan funds which may not be made available for a sizeable time period. When contemplating the application of a performance holdback, property owners should also ask themselves what the risks are, who controls the risks and if they are comfortable with the risk allocation. Further, property owners should always consider if there is another less costly or more palatable means to achieve their goals or control the risk.

In the post COVID market, property owners and lenders can keep those crystal balls hidden a bit longer and instead consider creative solutions to help both parties achieve their goals and mitigate risks. When implementing creative solutions like performance holdbacks, it is imperative that property owners and lenders engage sophisticated legal counsel that can thoughtfully and clearly document the agreed upon business solutions. Our Real Estate Capital Markets team at Nelson Mullins can help property owners, investors and lenders navigate creative solutions for the challenging lending environment. Please contact your Nelson Mullins attorney, or the author, to discuss.