

A broken loan in ninety minutes

Chapter 13. Eight steps, each with the one thing to write down. The output is four numbers and one question.

Loan / borrower		Prepared by	
Asset		Date	

Minutes	What you do	What you write down	Your file
0–10	Value the asset today: current income ÷ current yield	Value, and the loan to value	
10–20	Split the fall in value between income and yield	Which one dominates: it decides whether there is a plan	
20–30	Test every covenant; identify the strongest default	What you are entitled to do, today	
30–45	Price enforcement: discount, delay, costs, carry, discounting	The floor. Every other option is measured against it	
45–55	Compute the payoff indifference point	The cents figure that sets the range	
55–70	Model the extension; sensitise the exit yield and the income	Where the extension stops beating enforcement	
70–80	Price the consensual sale and the cooperation payment	What you can afford to pay the borrower	
80–90	Rank the four; compute the break-even probability	The one question for the credit committee	

The split (Chapter 1)	At origination	Today	If only this had changed	Share of the fall
Net operating income				
Yield				
Value				
Income alone				
Yield alone				
Interaction				

Covenant / default	Covenant	Actual	Result	Shortfall
Loan to value				
Interest cover				
Maturity				
Other				

Harbour Quay: 74 per cent of the fall is the yield. A loan whose problem is income has a business plan; a loan whose problem is the yield has only a holding period.

The four options on one page

Chapter 7. Every workout meeting should begin with this table and no other document. One discount rate, each option over its own timetable.

Loan / borrower		Prepared by	
Asset		Date	

Option	Present value	Recovery	Cash by	Provision	Principal risk
Enforce and sell					
Consensual sale					
Discounted payoff at ____ cents					
Extend ____ years					
Sell the loan (Chapter 16)					

The numbers that decide it	Formula	Your file
Indifference point	enforcement PV $\times (1+r)^t(\text{payoff}) \div \text{loan}$	
The offer against enforcement	offer PV – enforcement PV	
Zone of agreement	offer – indifference point, in cents and in euros	
Extension if it fails	enforcement PV $\div (1+r)^{\text{term}}$	
Break-even probability	$(\text{payoff} - \text{failure}) \div (\text{extension} - \text{failure})$	
Provision, each option	loan – present value (Chapter 12)	

The question for the credit committee: are we more than ____ per cent confident the letting plan works?

Harbour Quay, as corrected in the companion files: 46.42, 66.42, 56.89 and 80.33; 58.7 cents; 47 per cent. Present value at a single rate treats a three-year plan as if it were cash in six months: the probability is how you correct for it.

Pricing enforcement

Chapters 3 and 15. Four deductions compound; price them one at a time, then rank them.

Loan / borrower		Prepared by	
Asset		Date	

Step	Assumption	EUR m	Points of recovery
Market value today (income ÷ yield)			
Less forced-sale discount			
Gross proceeds			
Less transaction and enforcement costs (share of gross)			
Less holding costs (share of value a year × years)			
Net proceeds			
Less the cost of waiting: discount at r for t years			
Present value			
Recovery on the loan			

Route	Discount	Timetable	Costs	Transfer taxes	Liabilities acquired	Recovery
Receiver over the property						
Enforcement of the share pledge						

Test	Yes / no	Evidence
When enforcement is nonetheless right		
The borrower is the problem: diverted rent, obstruction, no information, a conflicting position elsewhere		
The asset is deteriorating faster than the market is recovering		
The alternatives require money nobody will put in		
Your own funding matures inside the workout period: you cannot hold		
Before relying on the route		
Share pledge exists and is perfected in the SPV's jurisdiction		
Local law enforcement memorandum: route, timetable, cost, out-of-court sale (Chapter 36)		

Harbour Quay: the forced-sale discount and the delay cost 23.87 of the 31.02 the process destroys. The share pledge route is worth 17 points of recovery.

The extension, year by year

Chapters 4 and 33. Cap the cash at the income, add unfunded interest to the balance, pay the capex out, cap the exit at the balance, re-test the covenants.

Loan / borrower		Prepared by	
Asset		Date	

EUR m	Year 1	Year 2	Year 3
Opening balance			
Net operating income			
Interest at the new margin			
Interest shortfall, added to the balance			
Amortisation paid from income left after interest			
Capex the lender advances			
Closing balance			
Net cash to the lender (never more than the income)			
Loan to value / interest cover, re-tested			
Compliant?			

The exit	Value
Year-3 income ÷ exit yield	
Less sale costs	
Repaid: the lesser of the net sale and the balance	
Fee at signing	
Present value: fee + annual cash + exit, discounted	
Recovery	
Break-even exit yield (net sale = balance)	

Exit yield	Value at exit	Repaid	Present value	Recovery	Beats enforcement?

Chapter 4 on Harbour Quay, corrected: the building never earns its interest in any of the three years, so no amortisation is paid; present value 80.33, recovery 97.4 per cent. If income stays at 5.15 it still returns 74.52: what makes an extension lose is a failure that ends in enforcement.

The first thirty days

Chapter 8. What happens in the first month decides how much of the analysis is still available later. Secured by acting, not by writing letters.

Loan / borrower		Prepared by	
Asset		Date	

#	Action	Why it cannot wait	Owner	Done
1	Reserve rights, in writing, without accelerating	Accepting interest without reservation can waive the default		
2	Trap the cash: withdraw the mandate on the rent account	Rent leaving the structure is the loss that cannot be recovered		
3	Instruct an independent valuation	Every option is priced off it; the borrower's number will not do		
4	Secure the information	Rent roll, arrears, leases, service charge, capex commitments		
5	Establish who the sponsor really is	Other lenders, other assets, other defaults		
6	Check the recourse carve-outs	The only leverage in a non-recourse loan		
7	Model the four options	Before the first substantive meeting, not after		

Item	Done / date	Note
The valuation scope: three numbers for the price of one		
Market value		
Market value on a special assumption of a restricted marketing period		
Estimate of the achievable price in a receiver sale		
The four inputs stated explicitly: yield, voids, capex, rent (Chapter 14)		
The reservation of rights letter		
Names the defaults; states that none is waived		
Discussions are without prejudice		
Sent before any further interest is accepted		
Repeated in every subsequent letter and in the standstill		

Do not negotiate against a valuation you have not commissioned. The commonest cause of a bad outcome is arguing about price with the borrower's number, six months old, produced for another purpose.

The standstill

Chapter 9 and Appendix D, part one. Cheap to give; the document in which the lender buys everything it will need later.

Loan / borrower		Prepared by	
Asset		Date	

Clause	What to insist on	On this file
Defined defaults	List them: a standstill on unspecified defaults waives what nobody has identified	
Duration	Days, not "until further notice". Sixty is usual; ninety the outside; extendable only on a met milestone	
Acknowledgement	Debt and defaults acknowledged, unqualified, with the amount stated	
Milestones	Dated: valuation, business plan, agent appointed, term sheet	
No waiver	The defaults continue and are not remedied by the standstill	
Termination events	Missed milestone, new default, insolvency step, breach of the information undertaking, any disposal	
Information undertaking	Monthly rent roll, bank statements, arrears, capex: dated, with a deadline and a consequence	
Cash	All rent to a blocked account from day one. Not negotiable, not deferred	
Costs	Borrower pays the lender's advisers, on account, in advance	
Standstill fee	Payable in cash, not capitalised	
Reservation of rights	Express, and repeated at the end	
Confidentiality	Mutual, with a carve-out for regulators and auditors	
Law and jurisdiction	Those of the facility agreement	

What the borrower should ask for in return	Agreed?
A cap on the lender's adviser costs	
An agreed operating budget, including leasing incentives	
What success looks like: what happens if the milestones are met	
Release on completion of a sale or a payoff, borrower and guarantors	

A ninety-day standstill with no dated deliverables becomes a twelve-month standstill in three renewals, and the asset gets worse throughout.

Documenting the outcome

Chapter 11 and Appendix D, part two. State what is given up, what is received, and close the matter so it cannot be reopened.

Loan / borrower		Prepared by	
Asset		Date	

Extension clause	What to insist on	On this file
Term	Defined, no automatic renewal	
Margin	Increased; payable in cash to the extent income allows	
Fee	At signing	
Amortisation	Scheduled, and a statement of what happens when income cannot pay it	
Interest shortfall	Expressly accrues, is funded by the sponsor, or is waived: never silent	
Cash sweep	100% of surplus after amortisation and approved capex	
New equity	In cash, at signing, funding capex before any lender money	
Capex	Approved budget, drawn against invoices, monitored	
Covenants	Reset to the plan with headroom, tested quarterly, plus a letting milestone	
Marketing longstop	The asset goes to market on a date if milestones are missed	
Security	Reconfirmed, gaps remedied, share pledge perfected	
Sponsor undertakings	No distributions, no affiliate payments, no new debt	
Waiver	Existing defaults waived on completion, not before	

Provision	In the draft?	Clause
A discounted payoff		
Release conditional on cleared funds, not on signing		
Longstop date, after which the defaults revive		
No-shop and exclusivity		
Full and final settlement: carve-outs expressly in or expressly out		
Source of funds confirmed; related-party buyer means an independent valuation and open marketing		
A consensual sale		
Agent named, marketing period, minimum price		
Who accepts an offer: the lender, with a duty to consult		
Waterfall of proceeds, including the borrower's completion payment		

The twelve clauses that decide the outcome

Chapter 31. About twelve of two hundred pages matter once the loan has defaulted. Read them in this order; answer on one page, with the clause beside each.

Loan / borrower		Prepared by	
Asset		Date	

#	Clause	The question it answers	Answer	Clause ref.
1	Events of default	Has one occurred, is it continuing, does it need declaring?		
2	Acceleration	Automatic, or does someone have to act, and who?		
3	Security documents (the list)	What is actually secured, and in which entity?		
4	Share pledge	Is there one, and is it perfected?		
5	Account bank, cash control	Can rent be trapped today, without consent?		
6	Financial covenants, cure rights	How many cures remain, and what do they need?		
7	Permitted disposals	Can the borrower sell without you; where do proceeds go?		
8	Prepayment, break costs	What does a payoff actually cost to complete?		
9	Hedging	Who is the counterparty; where does breakage rank?		
10	Recourse and carve-outs	Loss recourse or springing full recourse?		
11	Amendments and waivers	What needs unanimity?		
12	Transfers	Can you sell the loan; does the borrower have a veto?		

Trap	Checked	Note
The four traps		
"Continuing" is defined, and usually against you: a careless waiver switches off the cash trap		
Grace periods run from knowledge, not the event: an early acceleration notice is invalid		
The security list is not the security: check registration, notices to tenants and insurer, perfection		
Cash control is usually available earlier than people think: the mandate can go on a default		

The information you will not be given

Chapters 32 and 34. The borrower supplies derived information and withholds source information. Ask for documents, not analysis.

Loan / borrower		Prepared by	
Asset		Date	

What you need	What you are given	How to get the real thing	Received
Current rent roll	A summary by floor	The account bank statements: rent is what arrives	
Arrears	"Immaterial"	Contracted rent against receipts, month by month, for a year	
Lease terms	A borrower's schedule	The leases: breaks and rent-free periods	
Capex spent	A total	Invoices, contractor's applications	
The valuation	A one-page summary	The full report, special assumptions included	
Other creditors	Nothing	Filed accounts, charges register	
Rent leaving the structure	Nothing	The bank statements again, line by line	

Rent roll test (Chapter 34)	Threshold	Result	Verdict
Concentration: top three tenants' share of income	above 40%: a credit view on three companies		
Expiry cliff: income expiring or breaking within the extension	above a quarter: a second, worse problem		
Reversion: passing rent against market	over-rented: each expiry a step down		
Collection: contracted rent against cash, twelve months	gap above 3% not in the arrears report		

The three questions that reveal the most	Answer
What has been paid to the sponsor or its affiliates in the last twenty-four months, and under what agreement?	
Which tenants have approached you about their leases, and what did they ask for?	
What would you do with this building if you owned it with no debt on it?	

Before accepting a payoff

Chapters 5, 21, 22 and 23. Who is paying, what breaks, what the guarantee is worth, and what tax does to the timetable.

Loan / borrower		Prepared by	
Asset		Date	

Source of the money	What it tells you	What to require	Here
New senior lender	Someone will lend against the asset at this price	A signed, credit-approved term sheet	
Fresh sponsor equity	The sponsor believes in the asset at this price	Proof of funds	
Third-party buyer of the loan	It is a loan sale: price it as one	The right to run a competitive process	
Related party buying the property	The borrower is buying its own building at a discount	Independent valuation, open marketing	

The hedge (Chapter 21)	Answer
Counterparty: the lender itself, or a third party?	
In or out of the money, on the counterparty's close-out calculation (not a screen number)	
If out of the money: pari passu with the loan? Breakage on top of the payoff?	
If in the money and assigned: add it to the price you ask	

The guarantee (Chapter 22)	EUR m
Contractual cover: the lesser of the guaranteed amount and the cap	
× collectable share: unencumbered net worth, shared with the sponsor's other guarantees	
Discounted for the time to judgment and collection	
As points of recovery	

Tax, marked "to be confirmed" (Chapter 23)	Effect	Adviser / date
Debt forgiveness taxable in the borrower's hands: can it still complete?		
Transfer taxes: share route against property route		
Interest deductibility; lender taxed on accrued, unpaid interest		
VAT on a receivership sale: price gross or net?		

The credit committee paper

Chapter 26. A page and a half, in this order. The recommendation first.

Loan / borrower		Prepared by	
Asset		Date	

Section	Length	What it must contain	Drafted
The recommendation	3 lines	The option, the amount, the authority sought	
The number that decides it	1 line	The indifference point	
The four options priced	A table	Present value and recovery, identical assumptions	
What would change the answer	4 bullets	The switching values below	
What we do not know	3 bullets	Named, with who is finding out and by when	
The downside case	4 lines	What we recover if the recommendation is wrong	
Provisioning consequence	2 lines	Each option, not only the chosen one	
The decision record	Attached	Signed, dated, readable in two years	

Switching values	Base case	Switches at	What it means
Valuation			
Enforcement delay			
Forced-sale discount			
Exit yield on the extension			
Discount rate			

Sentence	Removed?	Replaced by
The four sentences that get a paper rejected		
"The borrower has proposed...": open with the lender's analysis, place the proposal against it		
"We believe the market will recover...": state the recovery required, let the committee judge it		
"Enforcement would be value-destructive...": quantify or delete		
"Subject to satisfactory documentation...": name the three terms, and what happens if refused		

Harbour Quay: 94.9 million, 0.47 years, 0.6 per cent, 10.3 per cent (corrected from 11.5) and 5.0 per cent. Five lines, and the committee knows how wrong you can be.

The decision record, and the twelve mistakes

Chapters 12 and 30. One page written at the time and never amended; then the mistakes, each priced on your own file.

Loan / borrower		Prepared by	
Asset		Date	

Decision record	Entry
Option chosen; amount and authority	
The four options, priced, assumptions on the same page	
The alternative rejected, and why, in euros	
The break-even the choice depends on	
The trigger that would change it, and who watches it	
What was not known at the date of the decision	
Review date; signatures	

Mistake	Harbour Quay	Your file
Comparing options at different dates	the extension looks 28% better undiscounted	
Market value used as enforcement proceeds	overstates by 21.09	
Forgetting carry	3.66	
Loan balance as the recovery target	the target is 46.42, not 82.5	
No indifference point	58.7 cents	
Accepting the borrower's valuation	up to 17 cents	
Missing the share pledge route	17 points	
Ignoring the hedge	0.39, either way	
Guarantee at face	overstated by 3.57	
Unconditional extension	spends the leverage	
Waiting without a break-even	73 bp a year	
Stopping a development	32.65	

When there are other parties

Chapters 17, 27, 36 and 37. A mezzanine, a syndicate, a second jurisdiction, a servicer: each changes who can say no.

Loan / borrower		Prepared by	
Asset		Date	

Decision	Usual threshold	Your agreement
Waiver of a financial covenant	Majority (66■%)	
Standstill	Majority	
Extension of maturity	All lenders	
Reduction of principal or interest	All lenders	
Release of security	All lenders	
Instruction to enforce	Majority	

Lender	Holding	Carrying value / entry price	Can it take a loss this year?	Preferred option

Mezzanine (Chapter 17)	Answer
Out of the money by, on enforcement	
Cure right: cost and number of cures	
Purchase option: at par or at market value?	
What its position is worth if the extension works (the buy-out range)	

Item	Answer	Source
Cross-border (Chapter 36)		
Law of the land, of the shares, of the contract		
Judgment recognition: add it to the delay		
Centre of main interests of the SPV		
Withholding tax after the restructuring		
Who signs if the directors resign		
Securitised (Chapter 37)		
Servicing standard and NPV test		
Legal final maturity of the notes		
Controlling class, and how close a control shift is		
Special servicing, workout and liquidation fees		