

Advisory:

Leasing Construction Costs: Tips for Navigating a Challenging Lending Environment

May 2023

Recent interest rate volatility and uncertainty in the real estate market have resulted in a tightening of the debt markets. This in turn has reduced the availability of financing for borrowers across the real estate sector. One area where we have seen this tightening arise is restricted liquidity for landlords under credit facilities that provide for availability of debt and/or reserves to fund construction of property improvements or tenant allowances in connection with leasing transactions (collectively, “TI Allowances”). As a result, we have seen a number of potential leases fail to gain traction and heavily negotiated leases fail to be consummated due to the landlord’s inability to obtain lender commitments to fund the negotiated TI Allowances.

In this client alert we will discuss steps that property owners, tenants and their respective advisors can take to help identify and mitigate the risk of incurring transactional costs for deals that may not be feasible in the current lending environment.

Identifying Issues in the Deal Structuring Phase:

- The following are helpful queries to assess transactional risk if the landlord intends to use borrowed money to fund TI Allowances:
 - o Are funds for TI Allowances coming from a reserve or are they available as loans?
 - o How much availability does the landlord have for funding of TI Allowances under the credit facility?
 - o Is lender’s obligation to disburse the funds for TI Allowances discretionary? If not, is the landlord aware of any conditions to funding that it expects it will not be able to satisfy (e.g. as a result of non-compliance with loan-to-value or other financial covenants)?
 - o Has the landlord recently drawn on the available funds? If so, were there any issues raised by the lender that are likely needed to be addressed prior to the contemplated funding?
 - o What is the scope of documentation required under the loan agreement for advances of TI Allowances, and are there limitations with respect to the timing and/or frequency of advance disbursements?
 - o What are the valuation trends for similarly situated improvements in the geographic area? Does the landlord have any concerns about their loan-to-value covenants being triggered during the buildout period?

Points of Emphasis in Lease Negotiations:

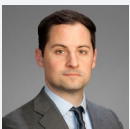
- Tenant business teams and their advisors should not make assumptions when finalizing TI Allowances as deal points. Tenants should probe the source of TI Allowances with their property owner counterparts during term sheet discussions.
- If a landlord does not have assurance that TI Allowances will be funded at the time a lease is signed, there are generally two approaches: (i) terminate the deal or (ii) provide for a lender approval contingency to provide time to secure funding for the TI Allowances, failing which either party may terminate the lease.

Advisory: (continued)

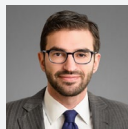
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- A tenant with leverage should require full recoupment from the landlord of out-of-pocket costs, including architectural and attorney's fees, if the Landlord fails to satisfy the TI Allowances contingency.
- In leases which tenants will perform fit-out work and receive TI Allowances as reimbursement for all or a portion of their costs, tenants should have strong remedies in place in the event a landlord defaults on its obligations – including clear and unambiguous rent set off rights in addition to the usual default remedies. Such tenants could also seek the landlord's posting of security (such as a letter of credit) or providing for a parent company guaranty for such obligations.
- Renegotiation of the underlying business deal is always an option, including:
 - o Adjustment of rent or other economic terms to account for the unavailability of funding for all or a portion of the TI Allowances.
 - o Consider whether other financing options may be available (e.g. leasehold improvement financing), even if less desirable.
 - Landlord – Landlord could negotiate with its first lien lender to allow for a second lien lender to fund the improvements. To the extent that the landlord is permitted to incur debt for specific purposes (e.g. purchase money secured debt or equipment financing), the lender could finance a portion of the buildout utilizing those applicable baskets.
 - Tenant – Tenant could take out a loan with the terms of the lease providing the tenant with a right to set off its financing expenses against the rent payments due under the lease. For smaller businesses, SBA loans may be available. Note that such an arrangement may also require that the landlord permit the tenant to grant a leasehold mortgage to the lender as collateral for the loan.
 - o For any such alternatives, the parties should be sure to consult with their accountants and tax advisors.

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