CREFC Europe

CREFC EUROPE
Due Diligence Guide for UK Investment & Development Finance

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Contents

Note: This guide considers due diligence primarily in the context of a loan to be secured on real estate in England and Wales. It may not be appropriate in connection with other types of asset, nor assets situated in other countries. Although this guide is also generally applicable for transactions in Scotland and Northern Ireland, the laws in those jurisdictions do differ from those in England and Wales and accordingly local advice will need to be taken from legal, tax and technical professionals in those jurisdictions.

This guide has been prepared as a guide only and does not constitute advice on the part of those individuals who have contributed to this guide or the organisations they work for. Readers are advised to consult relevant professional advisers should they require advice or guidance on any matter that is the subject of this guide.

The guide is designed as an overview only of the main issues the due diligence should address. It is not exhaustive and cannot deal with the specifics of every property or transaction, which may require additional due diligence beyond that contemplated within this document.

INTRODUCTION

A. INTRODUCTION

In 2011, CREFC Europe made a key decision. It recognised that one day the shadow of the Global Financial Crisis (**GFC**) would start to dissipate and that it was important to be timely in addressing several fundamental aspects of the real estate lending market. Firstly, numerous and important lessons had been learnt as a result of the crisis that should not be lost or forgotten as the property and financial markets improved. Secondly, the providers of debt in the future would not be exactly the same as the past; they would be a wider range of entities than simply banks and would represent a broader and probably more bespoke range of lending strategies. Finally, the fallout of human capital meant that educational and training support to the industry would be generally welcome.

CREFC Europe decided to address these aspects in a number of ways, one of which was to build up a volume of thoughtful and rigorous work offering best practice proposals for the complete value chain of property lending. Key areas of loan structuring, loan documentation, intercreditor principles and hedging were addressed by specific releases. An earlier version of this paper, published in 2013, sought to address the last key topic, namely due diligence.

In the years leading up to the GFC our industry did not distinguish itself in the extent and rigour of due diligence undertaken. Indeed, the underlying principle of why we undertake such work was lost. Commercial property lending consumes vast amounts of capital and the impact of imprudent lending is usually very material for each individual lender and at the macro prudential level. We can have the most trusted client relationships but it remains incumbent on all lenders to retain a healthy degree of institutional scepticism on deal facts until they are allayed by professional experienced investigation.

Every transaction has differences but there remains a core diligence process common to most. CREFC Europe brought together a wide range of leading experts to collate their experience into a single body of work to clearly convey a cohesive methodology.

Since that original paper was published in 2013, the operational intensification of commercial real estate continued and the market recovered and competition for mandates returned, before the (yet to be resolved) turmoil triggered by the pandemic. Many of the traditional large lending institutions remain active staffed with younger professionals that did not experience the boom and bust of the last cycle. At the same time, many new firms continue to enter the lending market, often led by former bankers but sometimes lacking the traditional back office and systems of the banking sector. There have also been changes in the legal and regulatory environment.

Following the publication of the original version of this guide in 2013 and a significant expansion and update in 2019, this 2022 edition delivers further updates and prepares the guide for use alongside a proposed new due diligence checklist in the coming months. Note also separate due diligence-supporting materials that we have recently published in relation to climate and the purpose-built senior living sector (with more to come from our committees and working groups). We hope the market will continue to benefit from this effort to promote good practice across our industry.

Finally, it is worth acknowledging that the nature of real estate risk has continued to evolve over recent years. Undoubtedly, there is significantly more operational risk in a lot of real estate that might traditionally have been regarded, with justification, as long secure income. The structural changes driven by technology, socioeconomic and climate change seem set to present many real estate assets with substantial risks (and opportunities) relating to repurposing, upgrading and retrofitting. For now, the predominant focus of this guide remains on the fundamentals of underwriting real estate risk for lenders, which we believe will remain important for the foreseeable future.

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PURPOSE OF DUE DILIGENCE

B. PURPOSE OF DUE DILIGENCE

B.1 What is due diligence?

Due diligence is the process of factual and legal investigation, research, analysis and discovery into the relevant borrower, asset, sponsor and other principal parties typically undertaken by a prospective buyer, lender or investor prior to entering into a transaction.

The precise scope of the exercise will vary depending upon the nature and value of the transaction and/or asset, the lender's existing knowledge of the borrower, timing and cost considerations but, in the context of the acquisition or development of, investment in or loan secured on, United Kingdom real estate, typically involves:

- an analysis of the buyer's/borrower's business plan, cost projections, appraisals and cash-flow forecasts with particular regard to the buyer's/borrower's ability to service the debt and repay the loan at maturity;
- a review of the buyer's/borrower's, solvency, funding and tax position, principal fiscal issues and other liabilities affecting the property, borrower or buyer (which for a development financing will include the borrower's ability to meet future construction cost liabilities including any cost overruns);
- enquires into the background, experience and credit record of the buyer/borrower, sponsors and/or other principal parties (which for a development property will include the contractors and professionals engaged and/or any ultimate buyer or tenant);
- a physical inspection of the property;
- a valuation of the property (and, in the case of a corporate purchase, financial and tax due diligence on the property owning company);
- an investigation of/report on the title to the property and/or legal restrictions affecting its use, an analysis of any risks associated with owning the relevant property arising from a legal or structural perspective and an assessment of the likely impact of other creditors, tenants or other persons also having interests in or rights over the property;
- where property is let, a review of the stability of the rental income stream, the credit-worthiness of the occupational tenants, the terms of the occupational leases and insurance and asset management arrangements;
- a 'health check' on the physical condition of the property and any buildings located on it, typically comprising reports on structural, measurement, planning and environmental risks;
- for a development financing specific due diligence on planning and rights of light matters and the underlying construction documentation package including a report from a project monitor appointed by the lender to report on the viability of the relevant development;
- consideration of the principal insurances (including any title or warranty and indemnity insurance being provided in connection with a seller's warranties under the relevant sale agreement);
- an assessment of the impact of the transaction upon existing contractual arrangements or permits; and
- consideration of the nature of the security to be granted and enforcement issues.

The purpose of requiring separate reports for different due diligence areas is to ensure that the best quality advice is obtained. Individual areas can be very specialised and necessitate particular training and expertise – a buyer/lender/investor should therefore always satisfy itself that the professionals or persons responsible for these are competent and experienced in the area concerned, are willing to grant reliance on their reports and are willing to accept an appropriate level of liability for their work which is backed by professional indemnity insurance. The credentials of any report provider can usually be checked with the report provider's relevant professional organisation or regulator.

B.2 Why undertake due diligence?

The main purposes of due diligence are:

- to establish whether the relevant asset or development is sound for the purposes of investment or loan security;
- to verify information given, financial projections and/or assumptions as to the ownership, (value and condition of the property) made in connection with the transaction parties, asset or transaction generally;
- to identify any risks inherent in the transaction or asset and mitigate these where possible;
- to comply with applicable statutory or regulatory requirements;
- generally to assist the buyer, lender or investor in analysing the legal and, to the extent possible, factual issues associated with the relevant transaction, and deciding whether to proceed.

Issues arising during due diligence frequently impact upon the viability of a transaction, the price paid for the property, the willingness of a lender to fund a scheme or other material terms.

B.3 Who should undertake due diligence?

Seller

This involves identifying material issues which may influence a buyer's or lender's decision to invest or offer finance and collating documents and other information which a buyer, lender and/or their advisors are likely to require. Undertaking this at an early stage (even before marketing a property) will:

- assist in identifying specific facts or matters (for example certain defects in title) which the seller may be legally required to disclose;
- help the seller plan how and when to raise these with the buyer and put the seller in a better position to deal with questions raised during negotiations;
- enable the seller to decide what representations and warranties can be given and what qualifications to these are appropriate or necessary; and
- generally ensure that the transaction proceeds quickly and efficiently and reduce the risk of material unexpected problems arising during the sale process.

Buyer

Any buyer of real estate should undertake due diligence to:

- test the assumptions made about the proposed investment;
- analyse the risks associated with the proposed purchase;
- ascertain whether all necessary information has been provided and, in light of any issues raised during the course of the due diligence process, what further enquiries or due diligence may be required;
- verify the accuracy of information provided (on the basis of which the decision to buy/invest is made); and
- determine any outstanding issues which may prevent the acquisition from proceeding, e.g. consents or permits required from statutory bodies or (for leasehold properties) landlords for the buyer to purchase, develop or charge.

Further financial modelling and/or adjustments to the business plan may be required in light of matters arising. Once the process is underway, material points can be raised during the negotiations and appropriate provisions (e.g. warranties) included in the transaction documents. These may help the buyer to shape its business plan, facilitate effective and efficient management of the asset after purchase and planning an exit strategy.

Lender

The two fundamental concerns of a lender are likely to be the ability of the borrower to repay the loan and the value (in both legal and monetary terms) of the security. These will shape the nature and extent of the due diligence – for example if the loan is being underwritten primarily on the basis of a sponsor guarantee, the level of property due diligence may be less than for a transaction where the asset is the only or primary collateral.

For a lender, the primary purpose of due diligence is to assist with the internal underwriting and credit review processes. To save costs and avoid duplication of reports, with regard to certain reports a lender will often seek to rely on the due diligence carried out on behalf of the buyer and, whilst in many cases this will be acceptable where the respective interests coincide, that will not always be the case and consideration should be given to undertaking an independent review. It is also critical, in such a case, that the lender is able to rely on the reports provided for the borrower (see F.2). The results should help to ensure that the appropriate provisions are included in the loan documents, the correct security is taken and all relevant conditions are imposed and satisfied.

B.4 When should due diligence be undertaken?

Legal and tax due diligence and financial analysis should start once the parties have settled terms in principle and normally after a term-sheet has been signed. Subsequently more detailed asset and structural enquires and reports should be undertaken, but it should be remembered that many individual reports will take time to prepare and a sufficient period therefore allowed for further investigation or to deal with issues arising.

Individual reports will generally only confirm information and the results to enquires at the time which they are prepared, although due diligence is an ongoing process which should be updated in the light of changes in circumstances (for example lenders usually require periodic revaluations to test the effectiveness of their security and the impact of any lease renewals or expiries and the insurances should also be checked regularly).

B.5 Co-ordination of due diligence

All parties and their advisors should understand what due diligence is being undertaken and any restrictions on its scope. This may be influenced by:

- the type of property and its planned use;
- the number and location of properties being acquired;
- whether the property or properties are let and the number of occupational tenants;
- the identity of the seller;
- when the seller purchased the property; and
- whether finance is required.

The extent of the due diligence should be in keeping with the value and importance of the acquisition to the buyer or investor and any risks identified should be analysed in the context of the transaction as a whole (so the risk profile associated with a portfolio of properties may be different to that of a single asset).

Documents, information and other due diligence materials should be organised into categories and scheduled so that a buyer/lender can more easily determine what is available and whether anything is obviously missing. For larger transactions, or where multiple bidders are expected, setting up a data room should be considered. Online data rooms should be secure, allow 24 hour and simultaneous access to different parties and be updated periodically throughout a transaction as and when new information becomes available (with users being notified of all updates). A complete and comprehensive index should be prepared and the content checked to ensure that documents are placed in the correct folders with updates sent to users when new versions of a particular document are uploaded.

It is critical to check that the various reports all cover the same property and that any assumptions made about the property are reasonable and accurate and tie in to the other reports. Accordingly copies of all reports should be sent to any due diligence coordinator and all other consultants who may be concerned with its contents (for example the legal report should be sent to the valuers and valuations to legal advisers to check the assumptions made relating to the extent of the property and tenancies, i.e. that the property the subject of the valuation and other reports is materially the same as that over which security is being taken).

Where a lender is relying on reports commissioned by the seller or sponsor these will be addressed to the lender by way of reliance letter. Reliance letters will need to be checked and negotiated to ensure the addressee wording is sufficiently wide for the lender's purposes (for example to ensure that they can be relied on by new lenders on syndication and that either they do not contain caps on liability or that any caps are acceptable). Such letters can take time to agree and should therefore be circulated and reviewed early in the process. In syndicated lending, it is appropriate to address the reports to the facility agent for and on behalf of all of the finance parties as this reduces the number of individual parties the reports need to be addressed to, allows coordination of any action taken against a report provider and facilitates an equitable distribution of any recovery proceeds. You may wish to consider using the form of reliance letter (with annotations and additional/alternative considerations) developed by CREFC Europe and available from this page: https://www.crefceurope.org/committee/6.

TRANSACTION DUE DILIGENCE

C. TRANSACTION DUE DILIGENCE

The following enquiries, checks and diligence relate to the commercial aspects of the transaction and will usually be undertaken at an early stage by or on behalf of the lender. The principal purpose is to verify that there are no material structural flaws in the transaction structure and that the information and appraisals upon which the credit decision to lend is based are accurate and reasonable in the circumstances.

Given the fundamental nature of these, and whilst some (especially legal) issues may be the subject of further reports, it would normally be prudent not to proceed to other levels and areas of due diligence until it is established that the results of these initial reports and procedures are, or are reasonably likely to be, satisfactory.

C.1 Statutory requirements (KYC and AML)

These checks and enquires must be made to comply with laws relating to the source of funds and money laundering (for a UK lender these include in particular but not exclusively The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLR 2017), which implement the European Union's 4th Directive on Money Laundering (2015/849/EU), the Proceeds of Crime Act 2002 (**POCA**, as amended by, inter alia, the Criminal Finances Act 2017), the Terrorism Act 2000, and (where relevant) the Anti-Terrorism, Crime and Security Act 2001 They are intended to reduce the risk of fraud or other criminal activity. There are two separate limbs:

- the requirement to identify, verify the identity of and otherwise conduct appropriate risk-based due diligence on the buyer or borrower and relevant related persons; and
- the duty to report any criminal or suspicious activity or circumstances.

The overall effect is to impose specific obligations upon organisations and professionals (including banks, funds, lawyers, accountants and estate agents) to conduct due diligence on the individuals and entities with whom they deal and the source of monies they receive.

This due diligence is not optional – any breach of the requirements could lead to criminal prosecution of the individual and/or organisation concerned.

For these checks to be carried out effectively, it is usually helpful for the borrower to provide a structure chart identifying all legal and beneficial owners of the property as well as the ultimate controller(s).

C.1.1 Customer Due Diligence or Know Your Customer (KYC)

A full summary of all the requirements applicable to every particular case is beyond the scope of this guide but generally KYC:

- is not only an identity check on the customer/client but also an enquiry into his/her/its ownership and control structure (in particular, identification and risk-based verification of the ultimate beneficial owner) and business, scope and location of operations and sources of funds;
- must be applied on a risk-sensitive basis (i.e. background information about the customer/client and its business must be obtained to assess the degree of risk) – the requirements for one person are not necessarily the same as those for another, similar entity;
- is a continuing obligation and should be renewed periodically with the facility agreement providing a contractual basis for periodic review (for example when a corporate entity changes its shareholders/members); and
- requires a risk assessment – it is not sufficient just to obtain the basic information; further enquiries should be raised or checks undertaken if appropriate.

Most lenders will have their own procedural requirements which should always be followed and, even if a particular lender is exempt from the legislation, the appropriate checks should still be undertaken otherwise it will be difficult if not impossible to transfer any part of the loan to another who is. These requirements should include checks to:

- verify the identity of the customer/client on the basis of documents, data or information obtained from a reliable and independent source (it is not normally sufficient just to rely on uncertified copies supplied by the customer/client);
- identify the beneficial owner(s) (if not the customer/client) and take adequate measures to verify identity (including, in the case of a corporate entity or trust, understanding its ownership and control structure); and
- obtain information on the purpose and nature of the business relationship.

The practical implications for the above vary but usually include (but are not limited to) (for individuals) reviewing passports and proof of address documents (e.g. bank statements and/or utility bills) or undertaking electronic identity verification and (for corporate entities) reviewing constitutional documents and shareholder lists.

Enhanced due diligence may be required in certain specified circumstances (for example, where the customer/client or beneficial owner is a Politically Exposed Person) or where the relationship has been assessed as presenting a high money laundering risk.

It is worth noting that in recent years, many lenders have widened the scope of their KYC and AML activity with a particular focus on identification and management of reputational risk, for example through adverse media searches. As a result, meeting a particular lender's KYC and AML requirements is becoming ever more qualitative – rather than the question being "can we lend", the greater focus is on "should we lend".

C.1.2 Money Laundering/Identification of Criminal Activity

The following are all criminal offences in the UK:

- to conceal, disguise, convert or transfer criminal property or to remove it from any part of the UK;
- to acquire, possess or use criminal property;
- to be concerned in any arrangement which a person knows or suspects or facilitates another person's acquisition, retention, use or control of criminal property,
  (all of the above being the substantive "money laundering" offences under the Proceeds of Crime Act 2002); and
- to agree to commit a money laundering offence, attempt to commit a money laundering offence, assist or encourage a money laundering offence, or aid, abet, counsel or procure a money laundering offence.

"Criminal Property" is property of any type (including real or personal property, hereditable or moveable property, money, things in action or other intangible or incorporeal property) which constitutes or represents, directly or indirectly, and in whole or in part, a benefit from criminal conduct. Criminal property can also include a "pecuniary advantage" obtained as a result of criminal conduct; for example where a person has criminally evaded tax or saved costs as a result of a criminal breach of statutory requirements). Money laundering offences can be committed in respect of criminal property within or outside the UK.

There is a defence to the substantive money laundering offences if timely disclosure of relevant information has been made to the National Crime Agency (**NCA**), and the NCA has granted "appropriate consent" (the NCA's preferred term for this being a "Defence Against Money Laundering" or **DAML**) to the acts which would otherwise be prohibited. Obtaining DAML provides a defence to what would otherwise be money laundering offences, but does not mean that a firm must proceed with a transaction, and does not provide protection against the commission of any other criminal offences, or against any civil liability. Accordingly, when it is suspected that a transaction may involve the commission of a criminal offence or use of criminal property, it may be relevant to obtain DAML, but there may also be other criminal, civil, regulatory and/or reputational issues which fall to be considered. Certain time limits apply to the granting of DAML, and the NCA has issued FAQs on making better quality DAML requests: https://nationalcrimeagency.gov.uk/who-we-are/publications/167-defence-against-money-laundering-daml-faq-may-2018/file.

In addition, those engaged in certain types of business (including banks, financial institutions and (when providing certain types of advice) law firms) are required to report to the appropriate authority any knowledge, suspicion, or reasonable grounds to suspect money laundering. Failure to do so is a criminal offence. POCA provides for reports by individuals in regulated firms to be made to that firm's Nominated Officer, who in turn has a personal responsibility to report to the NCA. (The DAML provisions referred to above are to similar effect: employees can seek DAML from their Nominated Officer, but the Nominated Officer cannot grant DAML until they have in turn received it from the NCA). Grounds for suspicion may arise, and therefore a failure to report offence could be committed, even if the customer/client had initially passed all KYC checks.

POCA also creates criminal offences of disclosing relevant information to a third party where such is likely to prejudice a money laundering investigation (POCA s.342: "prejudicing an investigation"), or, for persons working in the regulated sector, of disclosing that an internal or external report of suspicions has been made, or that an investigation is being contemplated or carried out, where the disclosure is likely to prejudice an investigation (POCA s.333A: "tipping-off").

There are further criminal offences specifically relating to terrorist financing as follows:

- inviting another person to provide money or property intending that it should be used (or having reasonable cause to suspect that it may be used) for terrorism;
- receiving, possessing or providing money or property intending that it should be used (or having reasonable cause to suspect that it may be used) for terrorism; and
- being involved in an arrangement whereby money or property is made available to another person with knowledge (or reasonable cause for suspicion) that it may be used for terrorism or an arrangement which facilitates another person's retention or control of terrorist property.

"Terrorist property" includes 'clean' money or property which is likely to be used for the purposes of terrorism (including any resources of a proscribed organisation), as well as the proceeds of the commission of terrorist acts.

Similarly to POCA, the Terrorism Act 2000 imposes obligations on those working in the regulated sector to report knowledge, suspicion, or reasonable grounds to suspect terrorist financing offences to the NCA. Other businesses and private individuals may also be subject to reporting obligations in certain circumstances. The Terrorism Act 2000 also creates tipping off offences.

The lender should take appropriate steps to satisfy itself that any funds which the borrower introduces are 'clean' and not the proceeds of crime, and must be alert to 'red flags' for money laundering or terrorist financing. Consequently a lender should usually investigate the borrower's business background (and, in the case of a corporate entity, its main shareholders/ultimate owners). The extent and nature of the enquiries will depend upon the standing, and the lender's knowledge and experience, of the borrower.

Warning signs which may trigger a need for additional diligence, or which might (if not satisfactorily explained) give rise to suspicion include:

- unusual transactions or an unusual series or pattern of transactions;
- arrangements or structures having elements (e.g. layers of ownership, indirect control, foreign participation) the basis for which has not been satisfactorily explained;
- unusual commercial terms (e.g. a transaction being entered into at a surprisingly high or low price, or at a loss, or a transaction with no apparent purpose);
- payments made in cash or apparently directly between parties but without satisfactory evidence of payment/receipt;

- payments made to or from third parties without satisfactory explanation of their involvement;
- involvement of jurisdictions without strong money laundering controls[1]; and
- undue secrecy.

C.2 Borrower/Other Party Due Diligence

This comprises basic checks and enquiries as to the legal structure and capacity of the buyer/borrower to identify (and if possible resolve) any major legal, financial or other issues. This diligence may also extend to other parties to a transaction, for example if the seller, major tenant, developer or other party is subject to a form of insolvency process. If any relevant party is not constituted or resident in the UK, legal, tax or other advice relating to all other relevant jurisdictions will normally be required.

C.2.1 Legal Structure/Ownership

Generally a single/special purpose vehicle or **SPV** is set up as property owner and/or borrower, Such an entity should have no material assets or business, no creditors or liabilities nor be party to any contracts other than those related to the loan and/or property so that (theoretically at least) it should be 'bankruptcy remote', i.e. the risk of the property owner becoming insolvent should be dependent solely on the financial performance of the underlying property the lenders are lending against. Ideally, the immediate parent of the SPV should also be bankruptcy remote to give the lender comfort that it is also unlikely to be insolvent at the point where it looks to exercise its share charge (assuming one has been taken).

In addition, a lender usually wants to know the complete ownership structure and ultimate owners of the property not only to satisfy itself that such persons are of a sufficient reputational and financial standing and satisfy KYC requirements (see C.1), but also because real estate investment financing is generally non-recourse (i.e. in an enforcement situation, the lender can only resort to the borrower itself and the assets charged as security). Consideration of the ultimate owners is therefore important – having a strong ultimate owner may give a lender comfort that, in a default situation, the owner will give support although, unless a formal guarantee is taken, there is no legally binding obligation to do so. The position is a little different in the context of development finance, where it is more common for the lender to have some recourse to the ultimate owners (to fund construction costs and/or cost overruns).

Most lenders require diligence in all relevant jurisdictions so where, for example, a UK property is owned by an entity constituted in another jurisdiction, which entity is owned by a third entity constituted in a different country, a lender will want to ensure that the laws of each relevant jurisdiction are compatible with taking or granting security over UK property or shares and that each entity is properly constituted with power and capacity to enter into the transaction. This comfort is usually given in the form of a legal opinion.

C.2.2 Legal Opinions

The form and extent of any legal opinion depends upon the nature of the transaction and the jurisdiction concerned but should specify the documents, assets and/or entities which are the subject of the opinion and generally confirm (from the legal perspective) that:

- all the necessary formalities have been complied with;
- (for corporate entities) the borrower/security provider is duly incorporated and has the necessary capacity and authority;
- the borrower/security provider is not subject to any formal insolvency process;

1 Parties established in a sub-set of high risk jurisdictions (identified for these purposes by the European Commission) must also be subject to mandatory enhanced due diligence (regulation 33, MLR 2017).

- the documents and security created are validly executed and legally binding on and enforceable against, all relevant parties; and
- (if the borrower/security provider is a corporate entity not constituted in the United Kingdom) that the choice of English law in the documents is compatible with, and judgments of the English courts are enforceable in, the relevant jurisdiction.

It should also highlight any post completion requirements (e.g. payment of taxes and/or registrations) that need to be addressed to perfect the security and should:

- be provided by a law firm competent to practice in the relevant jurisdiction;
- be addressed to the lender (or if there is a syndicate to the facility agent and/or security trustee on behalf of all lenders);
- allow disclosure on a non-reliance basis to the lender's advisors (e.g. auditors and, in some cases, rating agencies).

It is rarely possible to provide a totally 'clean' unqualified opinion and certain assumptions (for example that all parties other than those the subject of the opinion have full power and capacity to enter into the documents/ transaction) and qualifications (e.g. as to any provisions of the relevant law which might inhibit or restrict enforcement) will therefore usually be made. The reasonableness and need for these varies according to the matters and entities the opinion covers and the nature of the transaction, but it is important to ensure that these are all appropriate in the circumstances – in particular there should be no exclusions which effectively negate the value of the opinion itself.

C.2.3 Tax

There may be UK or other taxes which have to be paid and/or withholding requirements which may in some cases (normally in an insolvency situation in certain continental European jurisdictions) take priority over other creditors (even secured creditors) and/or adversely affect the income flow from an underlying tenant and/or a borrower which could delay, reduce or even stop altogether such income being applied towards servicing the loan.

Even where tax liabilities do not take priority over secured creditors, unpaid tax may allow a tax authority to wind up the relevant creditors which can adversely impact a lender in situations where the implementation of a business plan would serve to maximise recovery.

Where the borrowing entities are not in a fiscal unity this may also lead to tax leakage, even where they are all incorporated in a creditor tax friendly jurisdiction.

In other cases, an election or clearance from the UK or other relevant tax authorities may be required to mitigate the possible impact of taxes on the income flow from an asset.

Such issues are especially relevant where the borrower or property owner is tax resident or incorporated outside the UK, when specific tax advice (which can be included in the legal opinion mentioned above) in respect of any such other jurisdiction may also be needed. A summary of the main UK tax issues for financing UK real estate is set out at C.7).

C.2.4 Considerations for transactions involving non-UK jurisdictions

In transactions involving the acquisition or financing of entities or structures in non-UK jurisdictions, additional legal, financial and tax due diligence issues arise with regard, for example, to:

- the ranking of the relevant tax authorities above the lender (in some jurisdictions, a tax authority ranks above even a secured creditor);
- the costs and procedures involved in registering security in the relevant jurisdictions;

- the enforceability of English law documents and security in those jurisdictions; and
- the impact of any foreign taxes e.g. withholding tax and property taxes.

Local counsel's advice (including Scottish and Northern Irish law advice for transactions involving Scotland or Northern Ireland) should be sought to identify and mitigate the impact of these issues on the borrower's ability to service the loan and to identify any consents needed. The advice can be included in the legal opinion mentioned above.

C.3 Asset

In real estate lending, it is important to remember that the focus of the transaction is a physical asset and not just numbers in a spreadsheet or valuation. Full due diligence should always be carried out in respect of the property the subject of the security for the loan.

C.3.1 Inspection

A physical inspection of the property being acquired and/or offered as security is very important, principally to check what the property is actually like and the area in which it is located. As well as obtaining a basic feel for or impression of the property, other questions or issues which a prospective buyer or lender may wish to check or raise are:

- the conformity of physical outline of the property to any plan available;
- the occupants of the property (if not the legal tenants, they may be unlikely to renew, and an analysis of undertenancies may be appropriate);
- the nature and status of surrounding buildings (other similar or empty buildings nearby may negatively affect value and/or rent reviews);
- the area where the building is located (poor transport and infrastructure links, or other major development works in the vicinity, could deter future buyers and tenants);
- the physical condition of the building (a poor state of repair may be indicative of an owner or tenant in financial difficulties); and
- the likely costs associated with future ownership and maintenance of the building.

A physical inspection and confirmation that tenants listed on the tenancy schedule are in occupation is also an essential anti-fraud check – there have been a number of historic instances where a lender has advanced a loan on the basis of property particulars and/or leases which are counterfeit.

In the context of a development project, the site inspection should additionally specifically consider the potential issues arising from the proximity of the site with other buildings. Items to be considered include:

a) **Requirement for party wall awards:** these should be obtained for works at boundary walls and/or existing party structures, which include party walls, floors and partitions and or, excavation works up to six metres away from a building or structure on neighbouring land. The developer/borrower should serve the relevant notices on the adjoining owners from the outset of the project and the lender should ensure that the awards are in place prior to the commencement of relevant works so to avoid potential disputes.

b) **Rights of light:** as noted at D.2.3.2, rights of light give a property owner the legal right to receive light through defined apertures in buildings on their land. When a developer/borrower intends to erect a building in a way that blocks the light, there is a risk of injunctions being obtained preventing the works progressing. A suitable resolution strategy must be put in place to mitigate such risks. The developer/borrower must seek specialist advice from a rights of light surveyor who should advise on such a strategy. This should include a mixture of compensation and subsequent deeds of release and/or taking out suitable specialist insurances which should cover the potential claim as identified by the surveyor, although in practice a lender will not wish to be involved in remediation and so will require the full amount of their loan to be insured. It is advisable for the lender to obtain reliance on the rights of light resolution report, and to be listed as co-insured to the relevant insurances.

c) **Oversailing licenses:** this is more relevant on tight development sites where a tower crane or similar and/or scaffolding is to be used. Under English law a landowner owns the airspace above his land (unless it has been expressly excluded from the lease or transfer to him) and it is therefore trespass if a developer or its contractor allows an item to oversail (i.e. a tower crane or similar) across land owned by other parties. Given that an adjoining owner can obtain an injunction to prevent such trespass without needing to show that any damage has occurred, the developer/borrower and/or its contractor should seek a licence from third parties whose land may be oversailed by a crane or similar, permitting the trespass and setting out the terms of use of the tower crane. Such a license would have a limit on duration of the works and therefore suitable programming must be undertaken by the contractor to ensure that this is complied with.

In addition to the above, the following areas should be considered:

- The footprint of the proposed building to the overall area of the site. If the proposed building is going to occupy most of the site particular consideration should be given to the requirement for accurate programme and scheduling of deliveries since no layover areas / storage will be available on site.
- Abnormal costs associated with site development. These can include costs related to planning constraints, demolition of existing structures, excavation and levelling, enhanced foundations, environmental remediation, ecological constraints, flood risk mitigation, site drainage constraints (drainage retention), archaeological or ecological (particularly with respect to endangered flora and fauna) investigations and the provision of services.
- The previous land use should also be considered in the context of potential land contamination and proposed remediation works. Consideration should be given to site reconnaissance and intrusive surveys where applicable and these should be procured while appropriate allowances should be made within the wider development costs for both the surveys and the required remedial works. The lender should obtain reliance on such reports.
- When considering works on existing structures suitable surveys should be provided with the main focus being on structural integrity of the building to withstand the proposed works as well as an asbestos survey and the subsequent clean air certificates when any identified asbestos has been removed (see D.2.4).

C.3.2 Development/project appraisal

Development and project appraisal is an essential addition to the due diligence process. It is important to recognise that most due diligence workstreams are focussed on the condition and status of the asset at the point of loan origination only. The purpose of development and project appraisal differs in that its main purpose is to review how the asset and loan will perform in the future in the context of the developer/ borrower's business plan and to determine the potential implications for the lender.

Typically a valuation will only focus on the 'spot' value of an asset at any one pre-determined point of time. It will probably not consider the developer/borrower's business plan at all. Instead it will usually consider the generic business plan that a typical purchaser in the market might employ (in terms of leasing, development, refurbishment or any other asset management initiatives). Therefore whilst some level of development/project appraisal is always advised, it is particularly important in situations where:

a) the subject property is a development site, or the purchaser is planning significant development or refurbishment expenditure or other major asset management activity;

b) the buyer's business plan for the asset differs from that of a typical purchaser (this is particularly important where change of use is being considered); or

c) the developer/borrower or asset manager does not have a proven track record or experience in the relevant markets.

The nature of the development or project appraisal that will be required will vary considerably depending on the type of project, making it difficult to be prescriptive. The appraisal will usually be conducted independently of the valuation by a project monitor specifically appointed by the lender for this purpose but the valuer will be involved particularly as they are likely to be providing a projected valuation of the property's value based on implementation of the business plan. Where the appraisal is based on information or financial models received from the developer/borrower, these should be independently verified and tested.

The appraisal should always consider not only the valuation implications of the plan but the risk of the business plan not being delivered as planned. Examples include:

- a review of the developer/borrower's business plan making comparisons to those allowed for in the valuation;
- a full development appraisal to test project viability and assess future exit values; and
- a sensitivity analysis and scenario testing to determine the range of potential outcomes and risk exposure to test key commercial assumptions such as construction cost levels, market rents, resale levels, timescales and letting assumptions.

Furthermore, when considering a development project, the project scope needs to be clearly defined and an appraisal of the overall costs and objectives undertaken, to provide comfort that suitable allowances have been included to complete the works within budget and suitable contingencies are held. In particular, the following items should be reviewed:

Project Scope

- Is the proposed internal specification of the scheme in line with the targeted sales value and with the local market?
- Applicable statutory consents for the project (e.g. planning consent, listed building consent, conservation area).
- Conformity of projected construction costs with the desired level of specification.
- Accommodation schedule: conformity with business plan and planning consent.
- Consider the experience of the project team (developer/sponsor, main contractor, consultants) in delivering similar schemes.
- Construction technology risks.

Development Appraisal

- It is important to review the developer's development costs appraisal to ensure that it includes allowances in line with the project scope and current market expectations as well as appropriate contingencies. Further commentary on the anticipated elements of a development appraisal is included at C.6.

C.3.3 Management/advisory arrangements

The proper and efficient management of a property is important in preserving and/or enhancing its value and enabling any borrower to service and repay its debt.

A distinction should be drawn between (i) property management services, namely day to day administrative operations including rent collection and service charge management and (ii) asset advisory (or asset management) services, which comprise strategic asset planning designed to increase the property's income and value and include lease negotiations, planning applications, refurbishments and developments. Asset advisory duties are particularly important where the property has significant specific risks such as high vacancy, short leases, weak tenants, refurbishment requirements, structural issues or significant local competition.

Both property manager and asset advisor should have appropriate qualifications. Important considerations in this context are:

- experience and track record of asset managing comparable assets in the relevant geographic market;
- competence of staff and tenure with the company;
- reputation with lenders, tenants and investors; and
- systems and procedures for dealing with its duties (especially if these involve handling of rents and service charge funds).

The same party can be appointed in both capacities but, more commonly, different parties are engaged in which case there should be a clear separation of roles and, although there is likely to be some degree of overlap, each party should understand what is (and what is not) its responsibility.

The asset manager, if connected with the borrower/sponsor group, should not also be responsible for rent/service charge collection or expenditure, nor allowed to withdraw fees except in clearly defined and pre-agreed circumstances and should be capable of being replaced without undue penalty or delay if the borrower defaults.

A lender will be especially concerned that any asset advisor or property manager:

- is suitably qualified and experienced, and appropriately authorised or regulated;
- has clear and specific duties and responsibilities, which cover all areas likely to be relevant for the transaction and/or property concerned;
- has sufficient resources to enable it properly to carry out its functions (especially if it is will be holding any rent or service charge funds);
- has adequate and continuing professional indemnity insurance that covers all elements of its duties, including the arrangement of insurance on the assets;
- can be compelled to continue to provide their services at reasonable cost (to allow a lender sufficient time to find an alternative service provider and/or maximise value through their special knowledge of the scheme);
- can be replaced upon reasonable notice and at limited or no cost (or sooner if it is in material default) and can be obligated to conduct a proper handover for an incoming service provider. Particular consideration should be given to any employees whose duties relate substantially to the security property and any employment law protections in their favour, e.g. the Transfer of Undertakings (Protection of Employment) Regulations 2006 (**TUPE**) in the UK; and
- provides a duty of care undertaking in favour of the principal finance parties whereby (among other things) it agrees to pay rents into a specified bank account and acknowledges a duty of care to the finance parties.

A lender will also want to check that there is no material function which is (deliberately or inadvertently) outside either or both property manager's and asset advisor's engagement. This tends to be particularly relevant for real estate business which tend to be more operationally intensive, for example hotels, residential developers and data centre operators. Consideration should also be given to their fees and expenses – these should be fully disclosed, at market levels and covered in any financial appraisal, and the loan documentation should specify when and how these can be paid.

C.3.4 Contractors and professionals

Where the property has been relatively recently developed or refurbished or the lender is providing development finance, a lender should due diligence the contractors and professional team and the underlying building contracts, professional appointments and warranties. The professional team and the terms of its appointment are critical to the success of a development project. Therefore, professional consultants' appointment documentation, along with the underlying scopes of service, are a key consideration when undertaking a review of a development project. Areas that should be covered include the following.

- the expected contracts and appointments and scope of works and services of appointed contractors, sub-contractors and consultants; the form of appointments (standard forms/bespoke);
- key provisions: copyright, assignment and insurances; extent of liability; and the relationship between the proposed fee and the scope of service, including any benchmarking;
- provisions for any intellectual property relating to the scheme (e.g. drawings, proprietary systems and software);
- insurances, including levels of professional indemnity cover;
- obligations to deliver, and the form of, collateral warranties; and
- experience and suitability.

To an extent, the use of standard form appointments is preferred since these include industry-acceptable and widely recognisable terms and conditions as well a comprehensive breakdown of the scope of service.

However, on larger, more complex projects (construction value above £30m, say), bespoke appointment documents are more commonly used as it is likely that there will be a need to incorporate project specific terms & conditions. Even in such cases, it is advisable for scopes of service to be (or at least be based on) the industry standard for the various professionals involved.

A list of the standard form of appointments for each consultant is presented below:

Architect	RIBA Standard Agreement
Quantity Surveyor / Project Manager / Building Surveyor:	RICS Standard Form of Consultant's Appointment
Structural / M&E Engineer:	ACE Agreement 1 Design

These documents should be completed with project specific details, with the scopes appended to reflect the required service.

Where bespoke appointments are being used, a rigorous legal review from both the lender's and the developer's/borrower's solicitors is essential.

From a technical perspective, the following key provisions should be included:

- Collateral warranties: required in favour of both the borrower/developer and the lender. The inclusion of a specific timeframe for delivering this is also preferable, however, they should all be in place prior to drawdown of any funds.
- Assignment: the current market expectation is that a professional appointment can be assigned on no more than two occasions.
- Copyright: the consultant shall provide the developer/borrower (in this context, termed the **Employer**) an irrevocable and royalty free copyright. This should be reflected in the warranties to extend the copyright to the lender.
- Termination: the appointment should permit the Employer to terminate the agreement within a prescribed notice period (typically 30 days) but should limit the right of the consultant to terminate the agreement save for fundamental breaches by the Employer (e.g. non-payment).
- Liability period: the appointment should be executed as a deed to provide a 12 year limitation of liability period (if the appointment is executed under hand, liability is limited to 6 years).

- Net contribution: it is in the lender's interest to exclude any net contribution clauses from appointment documents as determining the amount of contribution as a result of underperformance between various parties may be difficult and time consuming to determine. A number of the standard forms of appointment include net contribution clauses by default and therefore may require amending.
- Professional Indemnity (**PI**) insurance: the preference would be to cover the value of the construction works, although this will often be a matter for negotiation. On large projects (where the construction value exceeds £30m) a commercial decision should be made as to the acceptable level of PI to be held since it is unlikely to be commercially viable for the consultants to obtain such a high level of PI.

The PI should be on an each and every claim basis and this should also be reflected in the appointment document. Further guidance on insurances is provided at E.

- Limit of liability: the limit of liability should be in line with the level of professional indemnity insurance required.
- Scope of service: the consultant's scope of service should be well broken down and preferably follow the RIBA Plans of Works 2013 with any exclusions clearly mentioned.
- Fees and payment profile: payment terms should be clearly defined with monthly payments on 30 day terms preferred. Payments should be spread across the project timeline while fees should be well broken down for each stage / deliverable.
- Agreed fees should reflect the scope of services, however as a rule of thumb professional fee allowances should be benchmarked as percentages of build costs:

Architect	1.5 – 2.5%
Civil / Structural Engineer	1.5 – 2.0%
M & E Engineer	1.0 – 2.0%
Cost Consultant	0.5 – 1.5%
Project Manager	0.5 – 1.5%
Other Consultants (Principal Designer, Building Control, Interior Designer and other specialists)	2.0 – 3.0%
TOTAL	7.0 – 12.0%

The relevant experience and the track record of each consultant should also be reviewed in the context of the proposed development. An established relationship between the consultants and the developer/borrower should provide additional comfort for the successful and timely delivery of their services.

C.4 Tenant credit analysis

The leases, the rental income from which forms an important part of the security underlying any commercial property loan, are only as good as the ability of the tenants to meet the obligations outlined in them. It is therefore almost always appropriate to undertake due diligence into the credit quality of tenants and, if relevant, their guarantors. The amount of diligence required is driven principally by the concentration of tenants in the relevant property or portfolio – the Debt Service Cover and Loan to Value (**LTV**) ratios for a loan which finances a property which is single let or let to a small number of tenants (for example an office block) is in principle far more sensitive to tenant failure than one secured on a multi-let building such as a shopping centre (although the retail sector may present risks of a more structural nature, as evidenced by the use of company voluntary arrangements (**CVAs**) by various retailers).

There are a number of resources and techniques which can be used to judge tenant credit quality and quantify the risk of tenant default in the short/medium term. The most common are shown below (these are usually most effective when used together to build up a detailed picture of a company's financial health in the context of the market in which it operates).

Rating agencies

Tenants who issue publicly tradable debt securities (e.g. bonds) may have a rating from one or more rating agencies. Standard & Poor's (S&P), Moody's and Fitch are the industry benchmarks, having been established for decades, but other agencies (including DBRS and KBRA for example) are increasing coverage and provide an alternative to the big three. Each rating agency has its own way of describing credit risk depending on the type of obligation issued. Long term obligations are described by an alphabetic designation system and a summary of this is shown below for the traditional big three:

	S&P	Moody's	Fitch	Comment
INVESTMENT GRADE	AAA	Aaa	AAA	Extremely strong capacity to meet financial commitments (highest rating assigned to a very small number of borrowers).
	AA+, AA, AA-, A+, A, A-	Aa1, Aa2, Aa3, A1, A2, A3	AA+, AA, AA-, A+, A, A-	Very strong to strong capacity to meet financial commitments (some large corporates fall into this category).
	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-	Generally adequate capacity to meet financial commitments, but susceptible to adverse economic conditions (these are the lowest investment grade ratings).
SPECULATIVE GRADE / 'JUNK'	BB+, BB, BB-	Ba1, Ba2, Ba3	BB+, BB, BB-	Speculative borrowers (less vulnerable to near term developments, but face major long term uncertainties).
	B+, B, B-	B1, B2, B3	B+, B, B-	Have a current capacity to meet financial commitments, but long term survival is uncertain.
	CCC, CC, C	Caa, Ca, C	CCC, CC, C	Highly vulnerable to failure
	D		RD, D	Default

If a rating is subject to change, the agency may add a suffix to the current rating grade to indicate whether an upgrade or downgrade is expected (e.g. Credit Watch Negative). The market standard shorthand for multiple ratings is (i) S&P (ii) Moody's and (iii) Fitch.

Credit ratings have a number of limitations including the fact that they are

(a) commissioned and paid for by the borrower;

(b) based only on information available to the rating agency;

(c) (notwithstanding the historic default matrix described below) relative measures of risk rather than specific statistical predictors of default; and

(d) not a directly predictive statistical measure of the risk of a default, but an indicator of the probability of a default for any given rating level (seen from cumulative historical default rates published annually by each rating agency).

Credit ratings are available through Bloomberg, the CRPR function and from each rating agency's web site (usually on the Investor Relations section of the borrower's website):

- https://www.spglobal.com/ratings/en/ (Standard & Poor's)
- https://www.moodys.com/ (Moody's Investors Service)
- https://www.fitchratings.com/ (Fitch Ratings)

A copy of the rating report from the rating agency, which contains commentary and analysis underlying the determined rating, can also be obtained but there is usually a cost to this. Where a borrower has several types of debt outstanding the most relevant rating is usually the senior unsecured debt rating which most closely approximates to the ranking of unpaid lease obligations in case of insolvency. It is the typically unsecured nature of lease obligations that renders landlords potentially vulnerable to CVAs.

Credit checking agencies

Credit checking agencies can be a useful source of information where tenants are smaller and have not issued publicly tradable debt securities. Two of the largest credit checking agencies are Dun & Bradstreet (D&B) and Experian but, whilst reports from both these contain useful data (especially where underlying properties are leased to large numbers of smaller tenants) it is important to remember that, given these agencies' high volume and low margin business models, there is a limit on the amount of analysis that each can perform and therefore individual ratings may present a misleading picture.

As a matter of good practice, external valuations should contain these wherever possible.

Experian

Experian have a system known as a Delphi score which indicates the risk of failure. The main Delphi score bands are reproduced below:

Delphi score band	Proportion of scored companies falling into band	Risk of failure
0	N / A	Serious Adverse Information or Dissolved
1 – 15	18.94%	Maximum Risk
16 – 25	9.92%	High Risk
26 – 50	23.94%	Above Average Risk
51 – 80	28.52%	Below Average Risk
81 – 90	14.08%	Low Risk
91 – 100	4.60%	Very Low Risk

Delphi scores and Experian credit reports may be purchased directly from the Experian web site (https://www.experian.co.uk/business-information/commercial-delphi.html).

Dun & Bradstreet

Dun & Bradstreet operate both a credit scoring system and a rating system. The rating system consists of a financial strength component and a credit risk indicator which is D&B's view of the likelihood of business failure within the next 12 months. The current financial strength and credit risk indicators are summarised below:

Financial strength indicators

Based on Net Worth	Based on Capital	Net worth (GBP)
5A	5AA	> GBP 35,000,000
4A	4AA	GBP 15,000,000 – GBP 34,999,999
3A	3AA	7,000,000 – 14,999,999
2A	2AA	1,500,000 – 6,999,999
1A	1AA	700,000 – 1,499,999
A	AA	350,000 – 699,999
B	BB	200,000 – 349,999
C	CC	100,000 – 199,999
D	DD	70,000 – 99,999
E	EE	35,000 – 69,999
F	FF	20,000 – 34,999
G	GG	8,000 – 19,999
H	HH	Nil – 7,999

Credit risk indicators

<table>
<tr><th>Risk indicator</th><th>Probability of failure</th><th>Guide to interpretation</th></tr>
<tr><td>1</td><td>Minimal risk</td><td rowspan="2">Good covenant</td></tr>
<tr><td>2</td><td>Low risk</td></tr>
<tr><td>3</td><td>Slightly greater than average risk</td><td>Satisfactory covenant but needs monitoring</td></tr>
<tr><td>4</td><td>Significant risk</td><td>Unsatisfactory covenant – may well default – confirm quantum of rental deposit</td></tr>
<tr><td>--</td><td>Insufficient information</td><td></td></tr>
</table>

So, a large company that is in difficulties may have a high financial strength indicator but a poor credit risk indicator (for example 4A3) while an unquestioned covenant would have both a high net worth and a strong risk indicator (for example 5A1).

The Dun & Bradstreet commercial credit scoring system is designed to predict the likelihood that a company will pay its bills in a severely delinquent manner (90 days or more past terms), obtain legal relief from creditors or cease operations without paying all creditors in full over the next 12 months. It assigns a commercial credit score class and a commercial credit score to each tenant. The current classes and scores are reproduced below:

Credit Score Class	% of Businesses within this Credit Score Class	Credit Score Percentile	Commercial Credit Score	Guide to interpretation
1	10%	91-100	482-670	Low risk of severe delinquency
2	20%	71-90	451-481	
3	40%	31-70	404-450	Moderate risk of severe delinquency
4	20%	11-30	351-403	High risk of severe delinquency
5	10%	1-10	101-350	

Dun & Bradstreet ratings and credit scores can be downloaded from their web site (https://www.dnb.co.uk/about-us/our-analytics/predictors-scores-ratings/scores-ratings.html).

Altman's Z-Score Model

A well-known model for predicting financial distress is Altman's Z Score model. This uses variables which have been shown to be effective indicators and predictors of corporate distress and attempts to predict the probability that a firm will enter bankruptcy proceedings by applying weightings to a number of key financial ratios as follows:

	Public company	Private company
Inputs	X_1 = (Current Assets – Current Liabilities) /Total Assets X_2 = Retained Earnings/Total Assets X_3 = Earnings Before Interest and Taxes/Total Assets X_4 = Market Value of Equity/Book Value of Total Liabilities X_5 = Sales/Total Assets	X_1 = (Current Assets – Current Liabilities) /Total Assets X_2 = Retained Earnings/Total Assets X_3 = Earnings Before Interest and Taxes/Total Assets X_4 = Book Value of Equity/Book Value of Total Liabilities X_5 = Sales/Total Assets
Model	$Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5$	$Z' = 0.717X_1 + 0.847X_2 + 3.107X_3 + 0.420X_4 + 0.998X_5$
Outputs	$Z > 2.99$ – low risk of failure $1.81 < Z < 2.99$ – elevated risk of failure $Z < 1.81$ – corporate distress	$Z > 2.9$ – low risk of failure $1.23 < Z < 2.9$ – elevated risk of failure $Z < 1.23$ – corporate distress

The model appears to be accurate in the short run, with an estimated 80%+ of firms with a Z score indicating corporate distress filing for bankruptcy within one financial statement period of the test being run but it is not recommended for use in analysing financial companies.

Credit default swap spreads

Credit default swaps (**CDS**) are a form of insurance entered into between a lender seeking protection from a credit risk and a counterparty who insures that risk. They are classed as swaps or contracts for differences as, when the relevant credit event occurs, the lender exchanges its loan for an agreed amount (usually the principal amount of the loan) with the counterparty. The premium charged by counterparty is known as the CDS spread and, the higher this is, the higher the perceived market risk of a credit event occurring to the borrower.

CDS spreads can be a leading indicator of corporate distress in the public debt markets, in contrast to credit ratings which tend to be lagging indicators, but they are generally only available for very large borrowers for whose debt there is a high volume of CDS trading. They can be downloaded from Bloomberg and, whilst not always directly comparable between all borrowers, a good rule of thumb is that CDS spreads of less than 250 basis points (**bps**) are indicative of lower risk and spreads in excess of 500bps a good indicator of current or near term corporate distress.

Financial statement analysis

Accounts for all UK listed companies can, for a small fee, be obtained from Companies House (https://beta.companieshouse.gov.uk/). Financial statement analysis is the most effective way of judging credit quality of smaller tenants although is also time consuming and may therefore not be suitable for large multi-let properties. It should also be remembered that company accounts provide a relatively delayed picture of the financial condition of a business.

There are a number of standard analytical techniques that may be applicable to a business which, if used properly, can give a good insight into the creditworthiness of a tenant. In order to calculate these it is necessary first to extract a number of data points from the financial accounts. These include:

Net debt	The net amount of financial indebtedness that a company is carrying. It can be calculated as follows: Net Debt = Short Term Debt + Long Term Debt + Unfunded Pension Scheme Liabilities + Current Tax Due + Net MTM on Derivatives − Cash and cash equivalents
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation. It is calculated by reversing all interest, tax, depreciation and amortisation out of net income (if the depreciation and amortisation expense is not shown on the face of the income statement then it can usually be found in the notes to the accounts).
EBTDAR	As EBITDA, but interest is not stripped out and rent payments are.
Interest	The net interest expense of the company

Having extracted these figures, the following financial ratios can be calculated:

Leverage ratio (Net debt/EBITDA): This shows how relatively indebted the tenant is by relating its net debt as a multiple of one year's EBITDA (the higher the ratio, the more indebted the company and hence the greater the risk of financial distress). A normal operating company that does not operate in a sector where high debt levels are normal (e.g. the property industry) with a ratio of less than 3x is generally considered to be conservatively geared. Ratios of between 3x and 6x are generally considered an indicator of a higher risk of default and ratios in excess of 6x (typical in leveraged buy-out structures) are generally considered dangerous to the viability of a firm.

Interest Coverage Ratio (EBITDA/Net interest expense): This shows how many times net interest expenses are covered by EBITDA (the lower the ratio, the greater the risk that the tenant will be unable to pay interest and may subsequently fail). A normal operating company that does not operate in a sector where high debt levels are normal would be considered conservatively geared if this ratio were in excess of 4x. Ratios of below 2x are generally a sign of over-gearing and an indicator of likely upcoming financial distress.

Rent cover ratio (EBTDAR/Rent): This shows the headroom between the rent the tenant is paying and earnings available to meet that rent. It is typically used in sale and leaseback and OpCo/PropCo transactions, where the property is let to a single tenant, as a method of increasing the amount of debt that is available.

A ratio of any less than 2x leaves the tenant vulnerable to not meeting its rental obligations as a result of a trading slowdown.

Apart from the ratio analysis outlined above, it is also worthwhile checking the following:

(a) audited accounts should state that the business is a going concern and the audit opinion should be unqualified (a qualified, disclaimed or adverse audit opinion is a sign of financial irregularities which may threaten solvency); and

(b) the firm should have an adequate liquidity profile – indications of this include having a reasonable amount of cash on hand, the presence of overdraft facilities and a staggered debt maturity profile (in the absence of these, even a firm with large profits and a high tangible net worth may be unable to pay its rent).

C.5 Financial modelling

Overview

The primary purpose of financial modelling in the context of commercial real estate financing transactions is to identify cash flow and value risks which may manifest themselves during the term of a facility and enable these to be managed and mitigated via loan structuring. It is almost always advisable to model future cash flows, as purely valuation driven lending may expose the lender to a number of risks, not least of which is the inability of the borrower and/or underlying security to service the loan and comply with loan covenants.

Commercial real estate debt modelling is complex and requires a disciplined approach to model creation. A good model will allow a user to take a large volume of non-transparent data (tenancy and property schedule) and will synthesize this into a clear, easy to understand projection. This can be used to gain an informative 'at a glance' picture of the underlying property/properties and enable the loan to be structured in a way that manages the cash flow and value risks of the transaction.

Given the bespoke nature of most real estate leases and transactions, a lender will usually prefer to create its own model but, if this is not practicable (and/or to check the lender's own model and analysis) an external party should be engaged to assist.

Model design

Any form of financial model should consist of three main elements:

Inputs	The drivers of the outputs need to be clearly identified as either statements of fact (e.g. the length of an in place lease) or assumptions about the future (e.g. the length of time it will take to re-let).
Calculations	Formulae that should not contain any hard numbers – calculations process the inputs to build up the model so that it can produce clear and useable outputs.
Outputs	Selected key calculations reproduced to give an indication as to how a transaction may perform and identify the key risks which may manifest themselves during the loan term.

Excel spreadsheets can be used in financial modelling but are extremely prone to error, as there is no built-in data integrity checking and no internal process for determining whether the formulae are logically or commercially correct. It is best practice to create separate sheets for inputs, calculations and outputs.

Type of model

Generally, commercial real estate financing models fall into one of two categories:

(a) Deterministic – the predominant type of underwriting model which employs defined and fixed inputs reflecting current reality or future assumptions and generates a discrete set of cash flows driven by these and shows show one particular (usually conservative) scenario.

(b) Stochastic – these replace certain key inputs with random variables, e.g. the Monte Carlo simulation, a modelling method run using multiple iterations of key inputs sampled from underlying probability distributions and a statistical analysis of the results (such as probability of default and loss given default) to provide a more holistic interpretation of the underlying risks. When designing or using such a model it is vital to determine whether the underlying probability distributions:

(i) are correct (historically stochastic models have used distributions that take a too narrow view of the range of potential outcomes); and

(ii) have been correctly correlated or correlated at all (this has tended to be ignored in the past resulting in a too narrow view of potential outcomes – i.e. lending transactions thought to be lower risk than they actually were).

Inputs required and responsibility for their provision

When underwriting a loan, the lender should list information requirements early to give all parties the ability to respond on a timely basis. Most of this information will also be required on an ongoing basis whenever covenants are tested (usually quarterly). Two broad categories of information are required:

Transaction level information

This includes information on the proposed facility such as facility amount, cost of the financing and the debt repayment profile:

<table>
<tr><th>Data point</th><th>Responsibility for provision</th><th>Data point</th><th>Responsibility for provision</th></tr>
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* Portfolio transactions only
** Optional

Property level information

This includes information on the terms of the leases, the valuation of the properties and assumptions as to re-letting:

Data point	Responsibility for provision	Data point	Responsibility for provision
Tenant name	Borrower	Lease end date	Borrower
Tenant guarantor*	Borrower	Lease break option dates*	Borrower
Type of space (office / retail, etc.)	Borrower	Lease extension dates*	Borrower
Tenant rating*	Borrower	Lease break penalty payments*	Borrower

Guarantor rating*	Borrower	Lease extension or non-exercise of break option incentives*	Borrower
Lease type (fixed term or rolling)	Borrower	Anticipated void period	Valuer
Property associated with lease	Borrower	Anticipated void rate	Valuer or lender (via the Valuation Office Agency web site (https://www.gov.uk/government/organisations/valuation-office-agency)
Net lettable area	Borrower	Void rates transitional relief	
Parking spaces*	Borrower	Anticipated service charge and insurance expense	Borrower
Current gross rental income	Borrower	Anticipated rent free letting incentive	Valuer
ERV at reletting	Valuer	Anticipated letting fees	Valuer
Indexation provisions*	Borrower	Anticipated new lease length to first break	Valuer
Lease start date	Borrower	Anticipated re-letting capex, net of dilapidations	Valuer
Lease income start date	Borrower		

* Not always applicable

Property level information – property data

Data point	Responsibility for provision	Data point	Responsibility for provision
Street address	Borrower	Property value	Valuer
Town	Borrower	Details of corporate and asset management non recoverables and their method of calculation	Borrower
Post code	Borrower		
Grade (prime / secondary / tertiary)	Valuer		
Build year*	Borrower	Details of major capex requirements and timing	Borrower & valuer
Details of head lease and payments*	Borrower		

* Not always applicable

Where it is not possible to get valuer input at the initial underwriting stage and borrower assumptions are made, these should always be cross referenced and confirmed by reference to the valuation prior to funding.

Creating the calculations

The model should be prepared in the following manner:

- calculations should be built up logically and step by step (if too many are done in a particular cell at once, these are difficult to check or later modify);
- the model should be quarterly and calculations should be, at least, quarter accurate (although day count accurate calculations are strongly preferable, particularly where a property or portfolio is leased to a small number of tenants);
- income calculations should be done at a lease-by-lease level (a summary total of the lease level calculations should then be brought into a separate sheet or section where the transaction level cash flows can be calculated);
- property disposals during the term should be catered for and the anticipated excess deleveraging from release pricing as a result of such disposals;

- apart from generating a projected cash flow, the model should include a stratification of the underlying property/portfolio (the calculations for this should be done separately);
- for a lender's basic underwriting cash flow, the model should generally be run to the earlier of first break or lease end – no extensions or lease renewals should be assumed;
- a premium should be built into the swap rate to allow for adverse interest rate movements between the underwriting date and the actual funding date;
- the model should be sufficiently flexible so as to add leases if appropriate;
- the model should include basic data integrity and error checks – for example if a lease is input as ending before the model start date, this should be flagged as a potential error;
- cash flows should be assessed using certain assumptions, for example relating to re-letting (the market convention for projected income calculations, and hence covenant testing, is to ignore these so that, if space is vacant, it is assumed not to re-let – a model should therefore only be used for covenant testing if it can assume a full run off of all leases and any other relevant provisions of projected rental income calculations).

Modelling conventions

There are several modelling conventions specific to the UK commercial real estate market:

- leases are assumed to be fully repairing and insuring (i.e. while a property or part of a property is let, the tenant is assumed to pay the rent and all outgoings);
- where there is a lease rent free period, it is assumed the tenant pays for all service charge, insurance, rates and other outgoings;
- generally, there is a short grace period (this may be longer for recently constructed properties) from the termination of a lease before the landlord becomes liable for business rates on the empty property;
- rent payments are due on calendar quarter end dates (usually 25 March, 24 June, 29 September and 25 December); and
- interest payment days are 2 to 3 weeks after rent payment days, i.e. between the 15th and 25th of the month following (usually April, July, October and January).

Outputs

The outputs of the model need to clearly and accurately identify and summarise the key transaction risks. They should be neither too detailed, nor so high level that risks are hidden. The following is a basic set suitable for most transactions:

- a granular annual operating cash flow identifying gross rental income, break penalties, void costs, letting fees, headlease payments and other non-recoverables to result in a net cash flow figure, less net capital expenditure (re-letting capital expenditure less anticipated dilapidations payments) and lastly, the amount of cash that is paid to the borrower (or needs to be injected) after financing costs and tax;
- a summary quarterly cash flow which starts with consolidated net rental income and deducts net capital expenditure, interest, tax and amortisation;
- key loan metrics on a quarterly basis (Interest Cover Ratio (**ICR**), Debt Service Cover Ratio (**DSCR**), yield on debt, Loan to Value (**LTV**) and debt per sq. ft.;
- a list of top 10 or top 20 tenants along with key data on their leases (term to first break, term to maturity, total rent paid, ERV, sq. ft. occupied, rent per sq. ft.);
- summary property details (income, Estimated Rental Value (**ERV**), area and vacancy);
- an annual breakdown of terminating leases by income for a ten or fifteen year projection period (i.e. 10% of income breaks in year 1, 5% in year 2, etc.);

- the weighted unexpired lease term and the weighted unexpired lease term to first break;
- the portfolio vacancy rate;
- a breakdown of the properties by income and space type (office, retail, logistics, etc.).

C.6 Construction and development finance

Where a loan is to finance a development project a detailed development appraisal must be provided. Lending decisions should be made based on the allowances and costs it anticipates, and hence their accuracy is of crucial importance to avoid funding shortfalls.

The lender and the developer/borrower should agree on the fundable costs as well as exclusions prior to agreeing the facility amount and the required equity contribution to fully fund the development.

On a fully funded basis the predetermined equity amount should preferably be injected first while the agreed facility should equate to the remaining cost to complete the development. Remaining costs to complete should include finance costs (up until the point that payments to the finance parties are anticipated to be made current), and an appropriate level of contingency, both for time and cost overruns. In other words, the lender should ensure that at any point during the project the remaining facility equates to the remaining cost to complete. If an unfunded cost overrun occurs or is projected to occur at any point, the provisions of the facility agreement should state that it is the responsibility of the borrower to fund these immediately prior to further drawings on the facility.

C.6.1 Financial model / development costs

The development appraisal should broadly include the following elements:

- **Land costs:** Purchase price, stamp/transfer taxes, legal fees, other fees (agents fees).
- **Planning costs:** Professional fees and statutory costs in relation to obtain necessary planning permits if the site has not been bought with full planning consent.
- **Construction costs:** this item should primarily include the cost of the fixed price contract / contract sum analysis depending on the chosen procurement route). However, other direct costs should also be included, such as demolition/enabling works, furniture, fixtures and equipment (**FF&E**) allowances as well as other items that are to be procured directly by the developer/borrower. In reviewing the development appraisal, the following aspects should be considered:

    a) Benchmarking: the contract sum should be well broken down and detailed pricing of each building element is preferable. A well broken down contract sum also allows better assessment and pricing of potential variations to the contract. The agreed costs should be benchmarked on a £/ft basis against both industry-wide databases and projects of a comparable size, scope and nature. The lender should seek such a benchmarking exercise and subsequent verification of the adequacy of the costs from its technical adviser/project monitor.

    b) Level of provisional sums within the contract sum: despite the name, a fixed price contract does not guarantee that the price is fully fixed. Some items may have been allowed as provisional sums meaning that these works have been unspecified or not thoroughly designed to allow accurate pricing. Cost certainty for these allowances is not achieved until works have been specified and instructed post-contract, when the initial budget allowance can be adjusted accordingly. A high level of provisional sums (10% or more) can indicate cost uncertainty for the development, so provisional sums should be identified and adequately budgeted for from the outset.

c) Preliminaries: these are the costs required from a contractor to run and administer the site, and obtain necessary insurances and bonds. The site's characteristics, the proposed building design and the size of the contractor's team affect this sum. Preliminaries would typically amount to the 10% - 15% of the build cost, but may be as much as 20% for complex buildings in tight sites (such as a tower in the City of London).

d) Overheads and profit (**OH&P**): this is the contractor's declared profit margin as well as an allowance to cover required management overheads. The level of OH&P is very dependent on market conditions.

e) Contractor's contingency / risk allowances: a risk allowance could be made by a contractor to reflect procurement and design risks. As this forms part of the fixed price contract sum, it is not available to be used by the developer/borrower.

f) Developer's/borrower's contingency / risk allowances: it is recommended that a separate contingency allowance outside the contract sum is made by the developer/borrower. This will also be under the lender's control providing additional comfort that the scheme will remain fully funded should unforeseen events arise. Risk allowances should be priced and budgeted on a project specific basis, but the following levels would be generally recommended, depending on the chosen procurement route:

	Design & Build	Traditional	MC/CM/ Self-build
Feasibility stage	10-15%	10-15%	10-15%
Pre-contract / pre-construction	5-10%	7.5-12.5%	10-15%
Post-contract / construction	5%	5-10%	7.5-12.5%

- **Professional fees:** there should be a detailed breakdown of the agreed fees for each consultant, cross-referenced with the agreed fee proposals and subsequent appointment documentation.
- **Statutory financial obligations / other development costs:** all financial obligations set as part of the planning consent should be included. In particular, where relevant allowance should be made for Community Infrastructure Levy (**CIL**), Section 106 obligations and other statutory undertakings including Section 278 and any local authority specific agreements. The allowances should be cross checked with the relevant deeds and agreements. Additionally, some of these agreements might include requirements for additional works to be undertaken and not only monetary compensation. It should be ensured that these works have been budgeted and programmed for either within the building contract or by the developer/borrower directly. Finally, suitable allowances must be made for project-specific costs in relation to party wall awards and the cost of insurance and/or compensation for rights of light.
- **Finance costs:** this should allow for any arrangement fees, rolled-up interest, non-utilisation fees, legal fees, valuation fees and project monitor fees as agreed with the lender. As development financing cannot usually be perfectly hedged, a degree of variability for the underlying interest rate should be included in floating rate financings
- **Marketing costs:** this should allow for any costs arising in relation with the marketing of the development. This could range from branded hoarding and website design to fully fitted out show rooms. The agency fees should be part of the development costs and subsequent profit calculations (although they are usually ignored when sizing the debt facility since these are paid at the back end of the development when it is fully let or sold and the lender has either already exited or covered these as part of an investment facility refinancing).
- **Sales costs:** where sales are on a unit basis (e.g. residential development) an appropriate degree of sales costs should be factored in as these will usually be owed to third parties such as sales agents.

C.6.2 Facility covenant testing

The facility covenants should be tested on an ongoing basis to ensure compliance with the facility agreement and the subsequent exposure of the lender. In particular the following should be tested:

- **Loan to value:** the lender should obtain a red book valuation report on drawdown to test the LTV covenant and provide it to its technical adviser or project monitor, who will ensure that the valued scheme is in line with the proposed construction costs, drawings and specification. Prior to practical completion, this will usually be tested on the basis of the Gross Development Value of the property (i.e. its value assuming the relevant development had been completed) against the drawn loan and any undrawn commitments. Once the scheme is practically complete, it should be tested on the Market Value.

- **Loan to cost:** this covenant should be tested on each drawdown an ongoing basis [and especially if there are additional works that might increase the anticipated costs which in turn might breach the covenant. It should be tested on both a spot basis (i.e. the loan compared with total costs spent at any particular point in time) as well as on a forward look basis (i.e. the total loan commitments compared with the latest project monitor estimate of costs to completion). Any increase in actual or projected costs will have to be funded by equity.

- **Contracted and/or stabilised income:** where a development is being built for the purpose of rental (e.g. a build-to-rent (**BTR)** scheme or an office) the contracted or stabilised (by reference to the valuer's opinion) income should be tested to ensure that cash flow after practical completion is sufficient to meet interest and amortisation.

- **Pre-sales:** where a development is being built for the purpose of sale (e.g. residential units), a lender should consider including requirements for pre-sales to be achieved prior to funding and/or during the construction period.

- **Equity contribution:** it is preferable that the equity contribution is made at the outset of the development, based on an inclusive and comprehensive development appraisal. In this way, funding shortfalls can be avoided while the scheme remains fully funded with the facility being sufficient to complete the works.

C.6.3 Guarantees and reserved commitments

Given timing and cost uncertainties associated with even the most well managed developments, a lender should seek to ensure additional credit enhancement is available if there are overruns. Depending on the financial strength of the entity providing the credit enhancement, this can take the form of either guarantees or reserved commitments.

Guarantees	A completion guarantee is an unlimited guarantee from an entity to practically complete the scheme irrespective of time or cost overruns. This type of guarantee provides the highest level of assurance to a lender (subject to the credit strength of the entity providing it). A cost overrun guarantee is a limited guarantee from an entity to pay cost overruns whether these are a result of cost increases or time delays. An interest shortfall guarantee is a limited or unlimited guarantee to pay interest costs following practical completion.
Reserved commitments	A reserved commitment is a tranche of a development loan that isn't intended to be drawn, but acts as a buffer which is available to fund cost overruns if a lender so allows. A reserved commitment should be sufficient to provide comfort to a lender, without exceeding the maximum level of indebtedness (on a fully drawn basis) that the lender has underwritten.

The choice of whether a guarantee or reserved commitment structure should be utilised is typically driven by the credit strength of available guarantors which should be underwritten on a similar basis to that described at C.4 for tenant credit analysis.

C.6.4 Cash flow

- **Anticipated construction expenditure modelling:** typically, construction costs expenditure follows an S-curve. Costs are absorbed slowly at the start when only individual packages can progress (e.g. piling), ramping up to peak monthly expenditure halfway through the project when multiple trades and packages can concurrently progress, before tapering off towards completion. The lender would expect the debt drawdown profile to reflect that, but the model should be updated on an ongoing basis. Cash flow assessment is also useful for further clarity on the current programme status of an ongoing development. If the developer/borrower is ahead of the initial cash flow forecast it could imply either that the project is progressing faster than anticipated, or it might simply reflect the front-loading of expenditure. Therefore, the lender should ensure rigorous monitoring and substantiation of all costs approved for drawdown.

  A further cash flow consideration is how the developer's / borrower's cash flow compares to the main contractor's (and sub-contractors') cash flows. Contractors should be paid on time on a monthly basis as per standard terms of a JCT contract while it should be ensured that payments to the supply chain are back-to-back with the main contractor.

  Ultimately, the financial projections in the model should be reviewed by a suitably qualified quantity surveyor acting as project monitor at inception, pre the first drawdown and then until the project has been completed and let or sold.

C.7 Tax

Tax due diligence

Whether lending against an asset in the UK or overseas, it will be important to check any tax issues relating to both the borrower (and any other security providers) and the asset. This will include any tax issues relating to the purchase price being paid for the asset, any historic issues relating to the asset itself and potential withholding tax issues on rent payments and/or payments of interest to the lender. In particular a lender will need to satisfy itself that:

(a) there is no withholding tax on any interest payments to the lender – or, if withholding tax could apply, the lender is able to rely on an exemption to receive interest gross;

(b) there is no withholding tax on any rents payable by tenants of the relevant property to the borrower;

(c) if VAT is payable on the purchase price of an asset, the borrower has sufficient funds to pay that VAT (or if VAT is not payable due to an exemption the borrower is expecting to utilise, the conditions for that exemption are met);

(d) if any stamp duty or other transfer tax or registration cost is payable on the purchase of an asset (or a corporate or title reorganisation), the borrower has sufficient funds to pay it (and that the borrower will make payments following completion within the applicable timeframes);

(e) either no registration taxes are payable on the lender's security or if payable they are paid by the borrower at completion;

(f) for corporate acquisitions, the property owner being acquired does not have any material actual or contingent tax liabilities and the corporate acquisition structure does not give rise to any such liabilities;

(g) there are no taxes which would rank ahead of the lender's security package on insolvency;

(h) where there has been a historic pre-funding ownership restructuring, there are no actual or contingent tax liabilities in the borrower or any other security provider arising from that restructuring; and

(i) any tax assumptions used in any financial modelling (for example, that interest payable on any element of the financing arrangements is deductible or that all VAT on construction costs can be recovered in full) are correct.

This section summarises some of the main UK tax issues that are likely to need considering when looking at financing a UK property.

Whilst a tax due diligence report may not be required for more straightforward UK deals, a lender is likely to require a tax report that covers both tax due diligence and structuring where the transaction is more complex. For example if it involves a corporate acquisition, or the ownership structure includes non-UK resident SPVs.

On more complex structures, a borrower may have a number of advisers on tax matters. The due diligence and structuring may be carried out by tax accountants, but any sale and/or loan is likely to be negotiated by one or more firms of lawyers. In such situations, it is important to ensure that any recommendations made by, say, the accountants following on from the due diligence are followed through – failure to do so could lead to unexpected tax costs which could affect the borrower's ability to repay the loan.

Withholding tax on interest payments

Withholding tax on interest is a payment on account of the tax liability of the recipient (the lender), which is collected from the payer. From a UK perspective, the main withholding tax obligation that will be relevant to UK commercial real estate financings is found at section 874 Income Tax Act 2007 (**ITA**). This states that, unless an exemption is available, UK withholding tax applies to a payment of "yearly interest" (sometimes called annual interest) if it arises in the United Kingdom and if the interest is paid:

(a) by a company (other than a building society) or local authority as principal;

(b) by or on behalf of a partnership of which a company is a member; or

(c) by any person (including an individual) to another person whose usual place of abode is outside the UK.

Yearly interest generally means interest paid in respect of an obligation intended by the parties to last for a year or more. Most loans secured against UK property will give rise to yearly interest.

The obligation to withhold is imposed on the person by or through whom the payment is made, i.e. the borrower or a person acting on the borrower's behalf. Note that there is no general requirement that the payer must be UK resident in order for UK withholding tax to apply: as long as the interest "arises" in the UK, the obligation to withhold arises – and so a non-UK resident owner of UK property may be required to withhold UK tax on interest payments. The issue of where interest "arises" can be complex; as a general rule, interest on a loan secured on UK real estate is very likely to arise in the UK. (Tax advice should be sought in any case where it is suggested that a loan that finances UK real estate does not "arise" in the UK.)

There are a number of exceptions to the obligation to withhold tax. These exemptions generally depend on the status of the lender. For commercial loans, the following exemptions are likely to be relevant:

- interest is paid on an advance from a bank (section 879 of ITA);
- interest is paid to a building society (section 880 of ITA);
- the lender is a UK corporation tax payer or a local authority (Chapter 11 of Part 15 of ITA); or
- a non-UK resident lender has the benefit of a double tax treaty which confers exemption from UK withholding.

Although beyond the scope of this Guide, if the borrower is non-UK resident, foreign tax legislation may impose an obligation to withhold tax on interest payments made by it. Again, consideration would need to be given to whether the lender can rely on the provisions of an applicable double tax treaty to mitigate any such non-UK withholding liability.

Determining the withholding tax treatment of interest payable under the loan, and the nature of any exemptions available to lenders (including new lenders following syndication) is particularly important in connection with negotiating the withholding tax and gross-up provisions of the loan agreement.

Withholding tax on rent

In the UK, withholding tax on payments of UK rent is only an issue for non-UK tax resident landlords.

The UK generally requires tax to be withheld from rents paid to a non-resident landlord at the basic rate of income tax (as at the date of this Guide, 20%) unless the landlord has registered under the Non-Resident Landlords Scheme (**NRLS**) to pay UK tax on its rental income by way of self-assessment.

Opting into self-assessment requires the consent of HMRC. This needs to be applied for by the landlord and any such application should be made as soon as possible after the landlord acquires the property. It is common in property loans for evidence of registration under the NRLS to be provided to the lender as a condition precedent given the cash flow implications of withholding tax on rent. The facility agreement will need to contain appropriately drafted representations and undertakings relating to the NRLS.

Whilst the NRLS can appear simple, in practice issues can arise in relation to compliance matters, particularly where the borrower entity is a partnership or unit trust. This is because such entities are generally tax transparent for UK (income) tax purposes, meaning that it is the partners/unitholders (rather than the borrower itself) that must register under, and comply with, the NRLS. A good understanding of the borrower's ownership structure will therefore be needed to ensure any NRLS risk is dealt with appropriately.

VAT

- Introduction

Where VAT is chargeable in relation to a UK property, then the owner of that property must account to HMRC for VAT on any supplies it makes of that property (for example under any lease it has granted to tenants). This follows on from the basic principle that VAT must be accounted for to HMRC by taxable persons who make taxable supplies in the course or furtherance of a business. In addition, it may mean that, where the borrower is using the loan to buy a property, it has to pay VAT on the purchase price to the seller (who will then have to account to HMRC for that VAT). However, in certain circumstances and provided specified conditions are met, a sale of property may be treated as not constituting a supply for VAT purposes (under the rules relating to the transfer of a going concern (**TOGC**)).

A taxable person can be an individual, firm or company (or group of companies) that is required (or has chosen) to be registered for VAT.

A supply includes most types of transaction. For VAT purposes, there are four main types of supply – standard rated (i.e. taxable at the standard VAT rate of 20%), reduced rated (i.e. taxable at a reduced VAT rate of 5%), exempt (so outside the scope of VAT) or zero rated (i.e. taxable but at a VAT rate of 0%).

It is therefore important to identify as part of any tax due diligence the VAT status of the property, and the resultant obligations imposed on the owner under the VAT rules, so that the appropriate representations and conditions precedent can be included in the facility agreement. Where supplies of land are standard rated, it will be important to ensure that the borrower has sufficient funds to meet its VAT liabilities as they fall due.

Generally the grant of an interest in land is exempt from VAT, but the "option to tax" (which allows a landlord to "elect" that VAT applies to its supplies of land) means that, for commercial property, supplies of the land are often subject to VAT. Less commonly, some supplies of land can be zero rated.

As a result, VAT on supplies of land (whether a sale or the grant of a lease) is a particularly complex area and tax advice is generally needed to address VAT issues, both as part of the due diligence process and in negotiating appropriate representations and conditions precedent. This is the case for all types of property, but residential property (including student accommodation) can raise particularly complex VAT issues.

The following is a very high-level summary of the VAT issues that may need to be considered in this context.

- Exempt supplies – land

As above, the grant of any interest in or right over land or of any licence to occupy land is usually exempt from VAT. For these purposes, "grant" includes a sale, lease or letting of land.

If the supply is not exempt (for example, because the option to tax has been exercised – see below), it is standard rated (i.e. taxable at the standard VAT rate of 20%), unless it is specifically zero rated.[2]

- Option to tax

A person who sells, or grants a lease out of, freehold or leasehold land (undeveloped) or who sells a freehold building (other than a new one) which would otherwise be an exempt supply, can opt to tax the land. Supplies of that land made by that person will then be standard rated. (The option to tax may also be referenced as an "election to waive the exemption".)

A person would opt to tax for VAT to be able to recover input tax (i.e. VAT payable by it on supplies that it receives relating to the land). Opting or not opting depends on the facts e.g. a landlord letting to a taxable tenant will usually opt to tax (i.e. waive the exemption), however a landlord letting to an exempt or partially exempt tenant, meaning one that cannot recover all of the VAT charged on its rent (e.g. a bank) may prefer not to opt to tax (as renting the property would then be more expensive and hence less attractive to the bank).

The option to tax rules are particularly complex, both in terms of the land to which they apply, and as regards revocation of options and anti-avoidance provisions. This is an area where specialist tax advice is generally needed.

- Transfer of business as a going concern (**TOGC**)

Under the TOGC rules, where a person transfers assets of his business to another person who will use them to carry on the same business (whether or not as part of any existing business) that transfer should be **outside the scope of VAT** provided that it occurs in the context of a transfer of a business or part of a business capable of separate operation as a going concern and certain conditions are met. Where TOGC treatment applies, the seller should not therefore charge VAT and the buyer will not have to pay VAT (Article 5 of the Value Added Tax (Special Provisions) Order 1995).

TOGC treatment can apply where there is a transfer of a property business, where the transferor has opted to tax the property, subject to various conditions being met (briefly, the transferee must also opt to tax (i.e. waive the exemption) and provide a specific notice to the transferee before the date of the transfer). Failure to meet the TOGC conditions means that VAT is chargeable on the sale of the building.

It is usually considered advantageous to benefit from TOGC treatment in relation to property that the seller has opted to tax, both for cash flow reasons and because stamp duty land tax (**SDLT**) is charged on the VAT inclusive consideration for the sale.

- VAT Group

A group of companies can apply to HMRC for group VAT treatment. The VAT group is then effectively treated as a single entity for VAT purposes so that supplies between the members are ignored.

VAT group members are jointly and severally liable for the VAT liabilities of other group members. For this reason lenders will usually look to ensure that borrowers and other security providers are either not members of a VAT group, or are only members of a VAT group with each other. This can sometimes conflict with the borrower's own historic VAT arrangements, and so can be an issue to discuss and resolve.

Interest deductibility

The borrower's financial modelling will include certain assumptions as to tax, including the availability of tax relief for interest expense. Since 1 April 2017, companies within the charge to UK corporation tax have been subject to new rules that generally limit relief for interest to a percentage of taxable profits. That percentage is either a fixed percentage (of 30%) or a percentage calculated by reference to the group's external borrowing costs as a percentage of group income. These rules are to apply to non-resident company owners of UK land from April 2020.

2 The government announced on 8 July 2020 that, as a result of the COVID-19 pandemic, the reduced VAT rate of 5% will temporarily apply to certain supplies within the hospitality sector, including the provision of sleeping accommodation in hotels, inns and boarding houses and the grant of licences to occupy holiday accommodation and charges for pitches for tents and camping facilities.

Whether – and how – these rules apply to a particular borrower is very fact-dependent, by reference to its own profile, and that of any corporate group of which it is a member. Part of tax due diligence is now likely to involve considering the reasonableness of any assumptions made as to the deductibility of interest by the borrower in its modelling.

Capital gains tax (CGT)

If a person sells UK land, any gain made on the sale is potentially subject to CGT (or, where the person is a company, corporation tax on chargeable gains).

Historically, UK CGT generally only applied to disposals by UK residents, though since 2013 CGT has been chargeable on all disposals of UK residential property where particular conditions are met. With effect from 6 April 2020, CGT is chargeable on all disposals of UK land, both direct (where the property itself is sold) and in certain cases of indirect disposal (i.e. where a person sells an interest in a company or similar entity that owns a substantial amount of UK land).

If a borrower has the ability to dispose of properties under the term of a loan, any CGT chargeable on a disposal will reduce the net disposal proceeds: it is therefore important that CGT is taken into account when giving approval for disposals. Similarly, CGT may need to be considered when considering possible enforcement options in a default scenario.

Stamp Duty Land Tax (SDLT)

SDLT applies to most land transactions in UK land including freehold purchases, leasehold assignments and grants, surrenders, assignments or variations of a lease. It is usually payable at 5% of the consideration, although the rates can be as high as 17% (where the supplemental 3% surcharge and 2% non-resident surcharge applies). Currently, SDLT is not charged on acquisitions of companies or certain other property-owning vehicles (e.g. unit trusts) but it is payable on transfers of partnership interests where the partnership owns UK property.

SDLT group relief is available for transfers of UK property between associated companies in certain circumstances. Where group relief has been obtained, in certain circumstances the relief can be clawed back, with the SDLT 'saved' by the group relief subsequently becoming payable. Part of any tax due diligence exercise will involve identifying any historic intra-group transfers where a SDLT claw-back risk still exists (resulting in a contingent tax liability in the borrower group)

UK stamp duty of 0.5% is payable on the consideration (net of existing debt) of a purchase of a UK company.

Community Infrastructure Levy (CIL)

The CIL was introduced by the CIL Regulations 2010 but only started having an impact in 2012 when the first CIL charging schedules were brought in around the UK. CIL could be a very significant cost to a borrower. It is a new levy payable to a local authority in relation to property development, to allow the authority to provide additional infrastructure in the area.

CIL will become payable (if there is a charging schedule in force in the area) on development which includes over 100 square metres of new floorspace, or where there is at least one new residential dwelling. A CIL charge could be millions of pounds. Note that in London, Mayoral CIL applies (since April 2012) and borough CIL could apply as well. Mayoral CIL is used specifically to fund the Crossrail project, whereas borough CILs raise funds for local infrastructure projects

The pre-conditions for a CIL charge arising start at the time a planning permission is granted. The charge will crystallise on implementation of the permission/consent and the sum will become payable on commencement of development. The default position under the CIL regulations is that the party liable to pay is any owner with a "material interest" (freehold interest or leasehold with more than seven years to run at the time planning permission is granted), which could include a developer/borrower (and could potentially include a lender if it goes into possession). It is possible under the regulations for anyone to assume liability to pay CIL in relation to a development (voluntarily) in which case that person will be liable for the CIL for that development unless and until that person revokes their assumption of liability (at which point the default liability position described above will apply).

CIL is relevant to development finance for a number of reasons. For example, if a lender enforces its security by exercising its power of sale and there is unpaid CIL, then this could adversely affect the value of the land and would therefore affect the amount the lender would recover from the security. Lenders may also be wary of giving their consent to development (e.g. 'no development without consent') where there is a large CIL charge to be paid in the future. CIL is usually not set out in any planning agreements or property contracts so must be considered separately. Evidence that consents/permissions have been obtained does not exclude the possibility of a CIL liability.

ASSET DUE DILIGENCE

D. ASSET DUE DILIGENCE

This section is divided into three sections covering, respectively, primary due diligence likely to be required in all or almost all cases; due diligence specifically required for construction and development finance; and additional reports that may be required in particular cases.

D.1 Primary Reports

These reports will be appropriate, and should generally be undertaken, in connection with all relevant transactions and types of property.

D.1.1 Valuation

Why undertake a valuation?

Valuation reports are part of the standard package of due diligence for investment in, or lending secured on, property. A valuation:

- underpins the investment or lending criteria;
- mitigates the potential for this to be based on over-priced assets;
- offers a summary of the salient findings of other reports; and
- crystallises the issues into an impact upon value.

All investors and lenders should therefore ensure that they can justify actions through professional valuations from firms with a coverage and skill-set appropriate to the portfolio or property in question.

Valuations are advised for all loans (whether senior or junior or for investment or development purposes) secured against real estate (whether commercial or residential) to support new lending, to monitor existing loans (in terms of adherence to financial loan covenants and to assist in providing consents to asset management processes, such as the grant or surrender of leases) and to underpin enforcement. In some cases, for example securitisations, different stakeholders may wish to commission their own valuation report, as reports will typically be drafted to be relied upon by a single client.

What is a valuation?

A valuation:

- is an opinion of the price that would be achieved assuming a willing buyer and willing seller for the sale of an asset (free of any corporate holding structure and encumbrances) at any given time assuming an adequate marketing period had elapsed; and
- a snapshot as of the valuation date – it does not provide any indication of the future performance of the asset (although opinions on this can be expressed through report commentary or additional requested valuation bases).

The most relevant standards for the valuation of property assets globally are set out in the manual RICS Valuation, Global Standards 2017, Incorporating the IVSC International Valuation Standard. This took effect on 1 July 2017 and is produced by the Royal Institution of Chartered Surveyors (**RICS**) commonly known as the Red Book. The incorporation of the International Valuation Standards (**IVS**) into this means that, although individual countries (for example Germany) may have their own standards, property valuations can be more easily carried out to a uniform standard. All formal valuations should prescribe that the valuation is in accordance with the above standards and any departure from these should be specifically mentioned in the valuation.

The minimum requirements of a valuation report (which should be reflected in a valuer's instructions) suitable for finance purposes are found in the Red Book, Part 4, VPS 1 Terms of engagement (Scope of work) and the main ones are:

- identification of the client and other intended users (addressees);
- the purpose of the valuation;
- the subject of the valuation and interest to be valued;
- the type of asset or liability and how it is used, or classified, by the client;
- the basis, or bases, of value and a statement of the valuation approach and reasoning;
- disclosure of any material involvement, or a statement that there has been no previous material involvement (this should be clarified and agreed prior to instruction);
- the identity of the valuer responsible and (if required) statements of the status of the valuer and that the valuer has the knowledge, skills and understanding to undertake the valuation competently;
- any assumptions, special assumptions, reservations, special instructions or departures;
- the extent of the valuer's investigations and the nature and source of information relied on by the valuer;
- any limits or exclusion of liability to parties other than the client and any consent to, or restrictions on, publication;
- confirmation that the valuation accords with these standards and also complies with the International Valuation Standards, where appropriate; and
- the opinion of value and valuation date.

Certain information should be provided in a valuation report beyond that required by RICS, namely details of any comparables, calculations, Argus files, cash flow forecasts and property details. The valuation will incorporate basic factual data, and it is the role of the valuer to interpret this information, amongst other factors, to form a conclusion of value.

A valuer will usually accept information provided by others in good faith, although he should apply professional common sense in this respect (for example if the information indicates a single tenanted property and inspection reveals a multi-let building, further investigation should be undertaken). A valuer should also review and consider other due diligence reports relating to the relevant asset where appropriate and be satisfied as to the area of the property valued (and require a separate full measurement survey if necessary).

The report will not always contain:

- an allowance for anomalies in title documentation (the property will be assumed to be free of encumbrances and restrictions of use if no title documentation is provided);
- an allowance for any contamination if there is no evidence after preliminary enquiries;
- an allowance for any environmental survey and impacts upon value (for example the habitation of protected species on land);
- an allowance for archaeological findings (except for a Residual Valuation where a developer would make an allowance for dealing with such works – for example a valuation of a development site in an historic town centre should contain a contingency figure for archaeology and a former industrial site suited to development a contingency for contamination) although the precise effect of these will not be appraised unless there is a professional report commissioned for that specific purpose;
- flooding (a report will detail the result of basic flood checks, however the assumption is made that full flood insurance is in place);
- a guarantee that the indicated boundaries are correct;
- a future valuation date;
- any unrealistic assumption (although a special assumption, for example of vacant possession), can be incorporated upon instruction); or

- where leases or a report or certificate of title are not provided, or not provided on all leases, an assumption other than that the leases are in a standard modern form (i.e. have no onerous terms and there is no privity of contract after the Landlord & Tenant Covenants Act 1995).

Many factors influence valuations and historic assumptions are not always appropriate to apply to a future date (i.e. it should not be assumed that a property will maintain its value throughout the period of the loan or investment). A valuation will be impacted by:

- the liquidity and speed of sale of the asset (a higher or lower price may be achievable over an extended marketing period);
- the level of demand for the particular real estate product within the market (lower demand decreases competitive pressure and can truncate the distribution of bids);
- the general availability of debt finance for the asset and its associated cost;
- market volatility and risk – it is fundamental to investment valuation that risk impacts upon value (explicitly or implicitly – investors require a higher rate of return to compensate them for increased risk and some real estate opportunities, for example development sites, are naturally high-risk); and
- lease events – a valuation with no special assumptions will assume that the current leases are in place (as these leases approach expiry there will be an impact upon valuation, for instance in a bull occupational market the impact may be positive as a higher rent can be achieved on expiry but in a stagnant or declining market with little occupational demand, the value is likely to fall and an investor can be faced with a negative cash flow due to taxes).

Lenders may also ask the valuer to express an opinion as to the property's suitability as security for lending. In such a case the valuer is being asked to help the lender assess risk rather than actually assess risk himself (the final decision on this should always be made by the lender) and should refer to the loan term (if known) or indicate an assumed norm (if not). The valuer may also comment on issues such as location, tenant quality, prospects for lease renewal and/or rent increase, lease length, capital expenditure requirements and the condition and specification of the property.

A valuer should provide valuations on appropriate bases to match both the asset being considered and the type of finance provided. The most common valuation bases are:

1) **Market Value:** this should be provided in most valuation reports (with only minor exceptions) and is the valuer's opinion of the price that could be achieved for a sale of the property (ignoring any holding vehicle) on the valuation date assuming that a reasonable marketing period has elapsed.

2) **Market Value on the Special Assumption of Vacant Possession:** this is often requested for commercial properties which are single let or have a concentration of lease events to assess the downside risk and is the valuer's opinion of the price that could be achieved if the property were sold on the valuation date with no leases in place (i.e. a special assumption as it does not reflect reality – this should nonetheless be reasonable and a valuation report containing such an assumption should comment on this).

3) **Market Rent:** this is the valuer's opinion of the rent that can be achieved for the property if let on market terms (the report should detail what these terms are and comment on the lease assumptions, for example the lease length and/or whether full repairing and insuring terms or a schedule of condition is appropriate).

4 **Reinstatement Cost Assessment:** whilst not a formal valuation basis this is often requested as part of a finance valuation for checking the level of buildings insurance in place (it is provided on a non-reliance basis and should not be used for assessing buildings insurance cover – if reliance is required a formal reinstatement cost assessment should be commissioned from a qualified building surveyor).

5 **Gross Development Value:** the valuer's opinion of the current Market Value of the property if a specific development of the property were completed. This basis of valuation provides important information in the context of development lending.

Valuation methodology is complex and should be considered by the valuer rather than the instructing client. Formal definitions of the relevant bases used should be included within the report. The various methods are:

- **Comparable:** this is based on comparable transactions, both occupational and investment, and generally considered reliable in a relatively liquid market;
- **Investment:** this is typically used where there is a regular income stream, which will be capitalised at an appropriate rate based on the Comparable method (different parts of the income stream may be capitalised at different rates and valuers will use different methods of analysis, for example "term", "reversion" and "hardcore" methods or discounted cash flow, often used where there is a complex or variable cash flow or where inputs can be easily estimated over a finite holding period);
- **Residual:** this works backwards from a gross development value and is very sensitive to inputs (so a client should expect a thorough explanation of these and equally the valuer will have high information requirements as small changes in assumptions will result in large changes in the value) and normally used only for development sites or projects – due to this extra risk and sensitivity such valuations are more expensive and should not normally be undertaken in isolation (cross and sensibility checks should be made with market orientated data on land values where possible);
- **Profits:** this is used for specialist trading properties, for example hotels and public houses, and based on the profits of the tenant's operations (when commissioning valuation reports for such properties it is especially important to establish the valuer's experience in the sector);
- **Depreciated Replacement Cost:** this is used (usually only for financial reporting purposes) for specialised assets that are rarely sold except as part of a sale of the entire business of which they form part (for example chemical plants, port facilities, sewage works, lighthouses, submarine bases and telecommunications structures) and based upon the cost of replacing the asset new, less allowances for physical and functional obsolescence – such valuations should always should be expressed to be subject to the adequate profitability of the business, paying due regard to the value of the total assets employed, and may also be further depreciated for economic obsolescence (although this element is usually addressed by accountants or specialist business valuers).

The 2014 industry report, A Vision for Real Estate Finance in the UK, made a number of recommendations for reducing the vulnerability of the financial system to the property cycle. The way lenders approach collateral valuation is at the heart of one of those recommendations, which received backing from the Bank of England and is being taken forward under the aegis of the Property Industry Alliance. The recommendation seeks to address the danger that reliance on market value-based LTV can encourage pro-cyclical lending and mask risk build-up (at portfolio and even whole market levels, thus presenting risks to financial stability as well as to individual lending institutions) as rising values create an impression of borrowing capacity. A follow-up report published in June 2017 considered three alternative long-term value methodologies, and the research programme of the Investment Property Forum undertook to conduct further research on methodologies (published in 2020 and available here), with a view to widespread adoption by lenders so that cyclical risks can be managed effectively. It is worth giving consideration to cyclical factors in the context of lending decisions.

Who should undertake a valuation?

A firm undertaking a valuation should be registered with RICS, and it is important to check that there is sufficient professional indemnity insurance in place for the scale of the property or portfolio involved (valuations will frequently include a liability cap, commonly in the region of 15% to 30% of the value, up to a stated maximum).

A valuer should be an RICS member and Registered Valuer, although is only prima facie evidence of qualification to undertake the engagement and does not necessarily mean that the valuer is suitable to undertake the work. It is therefore very important that a valuer can demonstrate a strong track record in the specific use class and geography concerned because of the heterogeneous nature of real estate as an asset class.

It is usual practice for the signatory to a valuation to be of Director/Partner level or above and have been qualified for at least 5 years. Different valuations will require different methodologies (for example investment valuations against trading valuations) – the valuer should have sufficient expertise and resources taking into account the number and nature or properties concerned.

It is worth noting that given the number of factors influencing valuations and the heterogeneous nature of property, for a lender to successfully claim damages from a valuer, the valuation will need to be incorrect by an amount that is greater than a generally accepted margin for error. With commercial property in the UK, this is typically 10-15% and may be more if the valuer has chosen to include a material uncertainty clause (something that has been common in certain periods of heightened market stress and uncertainty, such as during the early stages of the covid-19 pandemic). As a result, lenders should be aware that an assumed 60% LTV loan may in reality be as high as 66% (assuming a margin for error of 10%).

D.1.2 Legal certificate/report on title/property

This comprises a report on the title, and other principal legal issues arising, with regard to the asset financed and/or to be provided as security. It should test, from the legal perspective, the assumptions made and information given concerning the property upon which the valuation will have been made, and should state that, subject to any disclosures within the report, the title to the property is suitable for security purposes should the lender/mortgagee need to enforce. Ownership/title (including principal headlease terms) should be confirmed in all cases.

A certificate of title usually refers to a more formal report/summary of the issues covered in a standard form, either stipulated by the relevant lender/mortgagee or a professional body (for example in the United Kingdom the City of London Law Society has its own form of certificate of title).

A report on title is usually a less standardised and structured document more tailored to the nature of the asset and requirements of the transaction and each firm of solicitors will have their own standard form.

Both should cover all material and relevant legal and title issues and, in most cases, should be equally acceptable although it is worth noting that in the United Kingdom where only a report is available lenders will usually insist on an additional letter known as a wrapper letter which confirms the author of the report has considered and disclosed all the matters that would have been covered by, and gives all the confirmations that would have been given in, a certificate.

Preparation of a certificate of, or report on, title should include the following:

- an analysis of the results of searches of the Land Registry, local authority and any other entity where information on encumbrances and other matters affecting the property may be held;
- a review of the title documents, including subsisting mortgages and documents creating encumbrances to which the property is subject, as well as material rights the property has over adjoining properties which are integral to its use;
- (where the property is held pursuant to a lease) a review of the relevant lease and any superior leases;
- (where the property is subject to occupational leases) a review of the relevant leases;
- an assessment of replies to questions commonly asked of property owners prior to sale/charging;
- consideration of the potential effects of any material relevant legislation or general legal provisions (for example legislation relating to a tenant's security of tenure) which would qualify the specific provisions of any lease or title document).

The report/certificate should include an explanation of any defects/omissions, an assessment of the implications and (where appropriate – this is less common in certificates) recommendations for remedy or mitigation. Subject to this, the nature and extent of the report/certificate may vary (depending on the type and location of the property in question and the party undertaking the review) but should typically include (and in the United Kingdom a certificate would include) details of:

- property ownership and title, including any existing charges (i.e. that the owner has good and marketable title, and is beneficially entitled, to that property);
- (where the property is leasehold) the principal terms of the lease under which the property is held, in particular rent/rent review, tenant's obligations, insurance provisions, restrictions on transfer, underletting or charging, break clauses and landlord's forfeiture (termination) rights;
- rights, covenants, obligations and liabilities affecting (benefiting and burdening) the property;
- (where the property is let) leases to which the property is subject, including current tenant and any subsisting guarantor, the term, break clauses, rents/rent reviews, transfer or charging restrictions, insurance, service charge provisions, alteration restrictions, forfeiture and repairing obligations. Where a property is subject to a large number of lettings on similar terms, for example a shopping centre, it is common to see a detailed report of a typical or standard form lease with an exceptions report in a tabular format setting out the principal letting terms of the remaining leases and any material divergences from the standard form lease and/or for only a proportion of leases by value (say 70%) to be reported on;
- any consents required for the purchase or charging of the property, for example from a landlord under the lease by which the property is held or an adjoining third party with the benefit of a Land Registry restriction protecting a positive covenant;
- issues arising out of replies to standard enquiries of the owner (or seller if the transaction is acquisition finance) and/or disclosed by the results of usual searches (e.g. local authority, utility providers and the Land Registry);
- existing planning consents (including conditions attached) and planning agreements; for developments a separate, specialist planning report should consider the merits of further consents required (see further D.2.3);
- construction works carried out at the property in the last 6 years (including the details of any warranties and guarantees); if the property has been subject to significant construction work which completed in the last 2 years a separate specialist construction report would usually be prepared (see further D.2);
- any property tax issues (for example unpaid acquisition taxes or the ability for the borrower to recover VAT on expenditure for the property; and
- any material unusual issues arising (for example possible breaches of restrictions binding on the property and any defective title insurance policies).

Where (as is frequently the case given the borrower's and in turn its solicitors' knowledge of a property) the lender relies on a certificate or report on title prepared on behalf of the borrower by its solicitors, the lender's solicitors will normally produce an overview report, which will highlight any issues which should be brought to the lender's attention in the context of financing the purchase of that property and will primarily be focused on issues that impact on the value of that property and the ability of the lender to enforce which will then be considered by the valuer. However, such an overview report will not amount to a further due diligence exercise: the lender's solicitors will not reconsider any underlying documents and will solely review the underlying certificate/report and it is therefore critical to ensure that the lender can rely on the underlying certificate/report.

A legal report or certificate of title should always be undertaken by a fully qualified solicitor or firm of solicitors (this can be checked through the Law Society's website) which has sufficient expertise and experience of the type and nature of the property and transaction in question. It is important to check that the solicitor of firm of solicitors has sufficient professional indemnity insurance in place for the value of the property. In the United Kingdom it is uncommon for property reports or certificates to include a liability cap.

D.1.3 Building/site/mechanical & electrical surveys

This covers the physical quality of each building on a property from a technical, infrastructural, and architectural point of view and identifies potential or known technical deficiencies, compliance issues and risks. It should be used to supplement a valuation and the following principal objectives should be covered:

- the regulatory compliance status of the buildings and surrounding sites;
- an evaluation of the current quality of the buildings and technical installations;
- to develop measures to achieve compliance and to address potential or known liability and repair issues from a technical, infrastructural, and architectural point of view.

This should always comprise:

(a) a 'walk-through' site inspection/survey to observe and obtain information on the property's general physical condition and age, material systems and components and (to the extent possible) physical deficiencies and unusual features or inadequacies (although not testing, measuring and/or preparing calculations to determine adequacy, capacity, or compliance with any standard of any system or component); and

(b) a document review and interviews to assist understanding and identification of physical deficiencies and/or ongoing efforts and costs of investigating or remediating these (this does not consider the accuracy of such documents although a reasonable attempt to compensate for any mistakes or insufficiencies found should be made).

The precise components of such a report will depend on the nature and use of the property but they usually include a statutory compliance (including fire protection) review and investigations into the structure, fabric, external areas and mechanical, electrical and other systems of any building located on the property and an assessment of relevant Energy Performance Certificate (**EPC**) ratings. Optional items such as flexibility in use, pre-assessment according to sustainability schemes (e.g. LEED, BREEAM, DGNB), a spot check measurement of areas, assessment of opex costs, completeness of handover documentation and insurance reinstatement cost can also be included. Generally, however, and whilst there is likely to be some overlap with other due diligence reports, such a report will not normally cover environmental and/or valuation issues.

In respect of the Minimum Energy Efficiency Regulations (in England and Wales), any commercial property that has an EPC rating of 'F' or 'G' cannot be leased to new tenants, and leases with existing tenants cannot be renewed until measures have been undertaken to bring the property to at least an 'E' rating.[3] In the due diligence process this should be assessed by reviewing EPC certificates for the buildings and the accompanying recommendation reports. EPCs should be commissioned if not available (or, in certain cases, if an existing EPC is old and of potentially suspect quality). If the EPC has an F or a G rating your technical adviser should advise on the cost of bringing the building to an E rating. Note that this has to occur before a tenancy can be renewed or a new tenancy agreement completed.

A materiality level (commonly between £5,000 and £25,000) should be agreed to differentiate between material and minor issues and cost implications (often listed in capital expenditure projections) and an estimate of when such are likely to be incurred should be provided (usually short term = 1 year, medium term = 2-5 years and long term = 6-10 years). Optionally, items that are considered to represent significant health and safety concerns and / or major non-compliance issues may be classed as Immediate items that may be required to be addressed as a condition subsequent of the loan at the discretion of the lender, whereby a remedial option must be implemented by the borrower within a set time frame, failure to do so potentially resulting in a default on the loan terms.

Any report should ideally comprise:

- an executive summary;
- an explanation of its purposes and scope;

3 This minimum requirement will begin to apply to all existing leases from 2023. UK policy is aiming for a minimum rating of 'B' (or the highest achievable on a cost effective basis) by 2030, and there are proposals being developed for larger commercial buildings to be required to obtain and publish performance-based ratings.

- a general description of the property and its physical condition (including commentary on the suitability of building materials used and technical installations;
- an assessment of (material) building repair and maintenance costs; and
- photographs.

A risk assessment with cost implications should also be provided for material deficiencies or non-compliance issues identified (although these are sometimes not fully assessable due to insufficient information). The following risk assessments are commonly used:

- high = short term action required and clearance before signing recommended;
- medium = management attention is needed; and
- low = routine procedures.

D.1.4 Measurement survey

This is often time consuming and cost intensive. Site areas and lease areas should be cross checked as part of the commercial and technical due diligence on a desktop basis but, if significant discrepancies are identified, a full measurement survey should be performed. In practice, two measuring techniques are used:

- **on-site measuring:** this concerns the plotting of an existing building by a professional surveyor, using suitable measuring instruments; and
- **measuring off plan:** this concerns the graphic measuring from "as built" documents and computer files.

Different codes are applicable for the measurement depending upon the nature and location of the property. In addition, building or tenant specific agreements may need to be considered to achieve comparable results to existing rent rolls, lease contracts or other documents. Results should not only comprise floor plans but also highlight tenant areas and identify discrepancies in comparison to existing documents in order to facilitate assessment (by other consultants) on issues such as rental income and cash flows.

D.1.5 Environment/ground survey

CREFC Europe has developed a climate-related due diligence tool which is intended to help lenders consider the range of questions that might be directed at their clients in relation to the climate-related resilience and risks of the proposed collateral, having regard to the sponsor's strategy and governance of environmental matters. The tool can be accessed from this page: https://www.crefceurope.org/committee/19.

The valuation normally assumes the property is free from contamination, although a valuer would nonetheless be expected to mention any obvious signs of contamination. The report or certificate of title would usually exclude any consideration of environmental issues affecting the property save for any revealed by a desktop environmental search and any environmental consents or permits held by the borrower in respect of the property. If there are any obvious signs of contamination or the report or certificate reveal any environmental issues (or there is uncertainty) a separate environmental due diligence report should be obtained. Environmental due diligence has evolved as a result of increased awareness of potential issues and the passing of more stringent legislation (for example the Environmental Protection Act 1990), and the implications for a lender can be material if/when it has to assume ownership of, and responsibility for, an impaired property from an insolvent borrower.

Environmental due diligence, sometimes referred to as a Phase I Report or an Environmental Site Assessment, is undertaken to assess the potential liabilities and costs associated with a property (these can be significant and have a materially adverse effect on the property's value) which may result from contaminative activities previously carried out on the land. The risks posed by such sites vary but, whilst legally the liability associated with contamination clean-up costs rests primarily with the polluter, in some situations a property owner or lender may be liable (even where this can be passed on to a buyer or developer, the sale price is likely to reduce as a result).

Any property can potentially be impacted by environmental issues, but the risks are greater for those that have had an industrial use and fall into several categories:

- **Historic site use:** if the site has historically been used for purposes (for example as a landfill site, mining or certain industrial processes such as rendering) that may have left a legacy of contamination;
- **Current site use:** where current activities are causing contamination (this may not be immediately apparent if contamination is buried);
- **Surrounding land use:** surrounding properties currently or historically may have the potential to contaminate and/or adversely impact the property; and
- **Deleterious materials and compliance:** a building may contain materials (for example asbestos) which are subject to special control regulations or require careful handling and if in poor condition can impact the use of the building or incur significant remedial costs.

The scope of environmental due diligence varies depending on the property and the client's requirements. A typical Phase I Report will not include any sampling or testing but be based on available data and a site walkover. As a minimum, however, reports should contain:

- a property description and photographic record of areas of interest;
- a review of historic mapping and data for the property (this helps to establish the potential for historic contamination potential);
- a review of regulatory database information (this assists establishing the site setting and highlights potential local issues);
- a review of the geological and hydro geological setting (including an assessment of underlying geology and its potential to transmit contamination, mining and ground stability issues, and flood potential assessment);
- a visual assessment of all areas of the property and adjoining land, with particular attention paid to higher risk items such as above or below ground tanks, asbestos-containing materials, chemical storage, evidence of distressed vegetation, on-site waste disposal and chemical or oil staining;
- an interview with site staff (to determine the current pollution potential and the historic use of the site);
- a review of site documentation (to assess compliance in terms of asbestos surveys and labelling, waste disposal and review of historic site investigation data); and
- conclusions highlighting areas of potential concern and further work requirements.

Intrusive investigation is sometimes required if it is considered environmental contamination may be present in the ground. This can comprise a range of measures including installing boreholes, sampling soils and groundwater or assessing physical site characteristics such as the design and/or integrity of any underground storage tanks.

It is common in the UK that liabilities in the ground may only be released upon redevelopment of the site i.e. they do not pose a current risk to site users or the surrounding environs, however a change of use or redevelopment will trigger a planning requirement to assess and potentially remediate ground conditions. In this situation lenders may prefer to allow a potential cost, associated with land investigation and remediation.

The report should be undertaken by an individual and a senior reviewer with experience of similar projects and, whilst there are no specialised qualifications, typically practitioners will have an engineering or environmental sciences degree. Reports should be factual, conclude with details of potential issues and set out potential further work that could be undertaken to clarify areas of uncertainty, but will not normally include collection and analysis of soil, groundwater or building fabric samples.

D.1.6 Cladding and External Façades

Consideration should be given to fire safety when assets include cladding systems.

For buildings constructed under Building Regulations with an initial notice issued after 30 August 2019, comfort is provided to lenders and occupiers as the changes introduced banned combustible materials in a building's façade.

For buildings constructed under older Building Regulations, consideration must be given to the materials used in the external façade and potentially an intrusive survey should be instructed to establish the build-up and the fire rating of materials used so a lender or investor can inform their decision making around remedial works, if required.

For residential assets of more than 18m in height, members of UK Finance or the Building Societies Association (**BSA**) have required EWS1 forms for mortgage applications (though the EWS1 form is not a statutory requirement). The EWS1 form confirms (for valuation purposes only – it is not a building safety document) that the external wall system has been reviewed by a qualified professional. The EWS1 form provides two options:

- Option A – used when the cladding material and insulation in the external wall systems are known to be of limited combustibility. This will result in a rating of either A1 (no attachments such as balconies whose construction includes significant quantities of combustible materials), A2 (there is an appropriate risk assessment of the attachments confirming that no remedial works are required) or A3 (there may be potential costs of remedial works to attachments).
- Option B – used when the external wall system is thought to contain combustible material. A fire engineer will then be required to undertake a risk assessment to establish whether the risk is deemed negligible or remedial works are required. This will result in a rating of either B1 (the fire risk is sufficiently low that no remedial works are required) or B2 (an adequate standard of safety is not achieved and remedial and interim measures are required.

A number of mortgage debt providers are requiring EWS1 forms even for buildings with a height below 18m. There is an expectation that the EWS1 form requirement may be extended to include all multi-storey and multi-occupancy buildings in the future. Generally speaking, a rating of anything other than B2 makes a property suitable for institutional mortgage financing.

When financing development projects or stabilised assets, a lender should review (and the project team should retain) the building's Fire and Emergency File recording the installation of all active and passive fire protection measures. During construction, the IMS should monitor the compilation of this and flag any issues to the lender. In the context of the financing of a completed project, the lender should instruct a review of the file by a qualified technical advisor.

D.2 Construction and development

When financing an asset under development, it is necessary to review and critically appraise its procurement, the contractual arrangements between all the project parties as well as the development programme along with all the necessary statutory consents and surveys.

D.2.1 Procurement route and building contract

D.2.1.1 Procurement routes

Procurement routes in the context of development projects dictate how the project will be delivered, effectively the sequencing of the design, tendering and construction phases of a development.

Development projects can be procured via four distinct routes: Each route has a different time, cost and quality risk profile and their suitability depends on the borrower's requirements, experience and risk appetite (which are typically in line with those of the lender). The four procurement routes are.

- **Traditional procurement:** when a project is traditionally procured the developer/borrower appoints a design team who fully design the works, which are then tendered (usually on a competitive basis). The selected contractor then enters into a fixed price contract and constructs the works based on the provided design and specification. Under this procurement route the developer/borrower maintains full control over the quality and specification of the scheme, but design risks are retained. This procurement route may take longer due to its sequential nature, but it offers greater time and cost certainty than other routes whilst reducing the possibility of contractor risk pricing hence being more competitive.

- **Design & Build:** a design & build project is one where a certain level of design is undertaken by the developer/borrower team. The point to which this initial design is taken will depend on the project's nature but varies from RIBA stage 2 design (concept) to RIBA stage 4 design (technical). Subsequently, this initial design (known as the **Employer's Requirements**) is used as a basis for contractors to tender on both the construction of the works and the conclusion of the detailed design (the **Contractor's Proposals**). Once a successful contractor is identified, construction works progress in parallel to detailed design.

  This procurement route may take less time due to the design and construction overlap, but it may be less competitive on price due to the fact that the design risk is transferred to the contractor, who will charge accordingly. The extent of potential risk pricing varies depending on the level of detail in the Employer's Requirements.

- **Management Contracting (MC):** under the MC procurement route, an initial design is undertaken by the developer/borrower's design team to a level sufficient to appoint a Management Contractor on the basis of their overheads / management fees and cost of preliminaries. Once appointed, the management contractor will work with the design team and provide buildability advice. On an ongoing basis, each design package is designed, tendered and then constructed with the management contractor acting as the main contractor and managing the discrete sub-contractor packages, who are contracted to the management contractor.

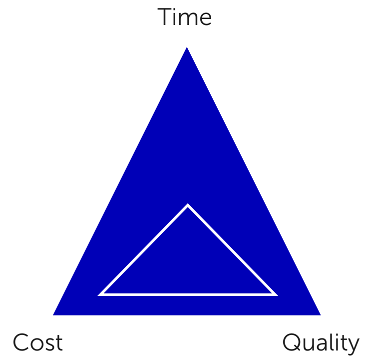
  This route offers time savings due to the overlap of design, tendering and construction, but does not provide overall time or cost certainty due to the lack of a single fixed price building contract. The competitiveness of projects under this route will be heavily influenced by any pain/gain agreement between the developer/borrower and the MC.

- **Construction Management (CM):** this route is similar to the MC route, with two main differences. Firstly, due to the fact that the Construction Manager is providing a consultancy role, they are appointed from the outset along with the wider design team, on the basis of their proposed fees (potentially saving even more time compared to MC). Secondly, under a CM procurement route, the discrete sub-contractors are contracted directly to the developer/borrower, increasing their risk profile as the non-performance of any of the sub-contractors is a developer/borrower risk.

  The current market consensus favours the Design & Build procurement route, due to the transfer of design risk to the contractors whilst retaining control of the key design aspects through the pre-contract Employer's Requirements. However, selecting a procurement route should always be undertaken on a case by case basis considering the project's specifics as well as the developer/borrower and the lender's risk profiles and time, cost and quality constraints.

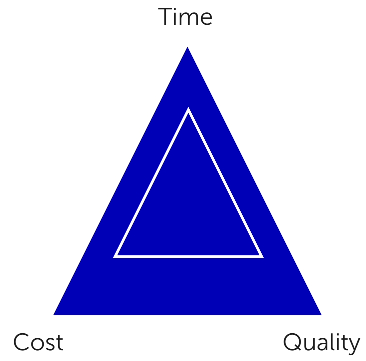
Below is a visual representation of the procurement routes, along with their time, cost and quality risk profile:

Traditional



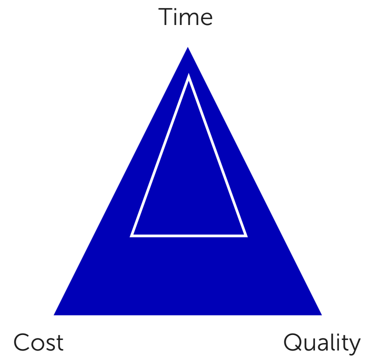
Advantages	Disadvantages
Time certainty	Overall Duration
Quality certainty	No risk transfer
Competitive	

Design & Build



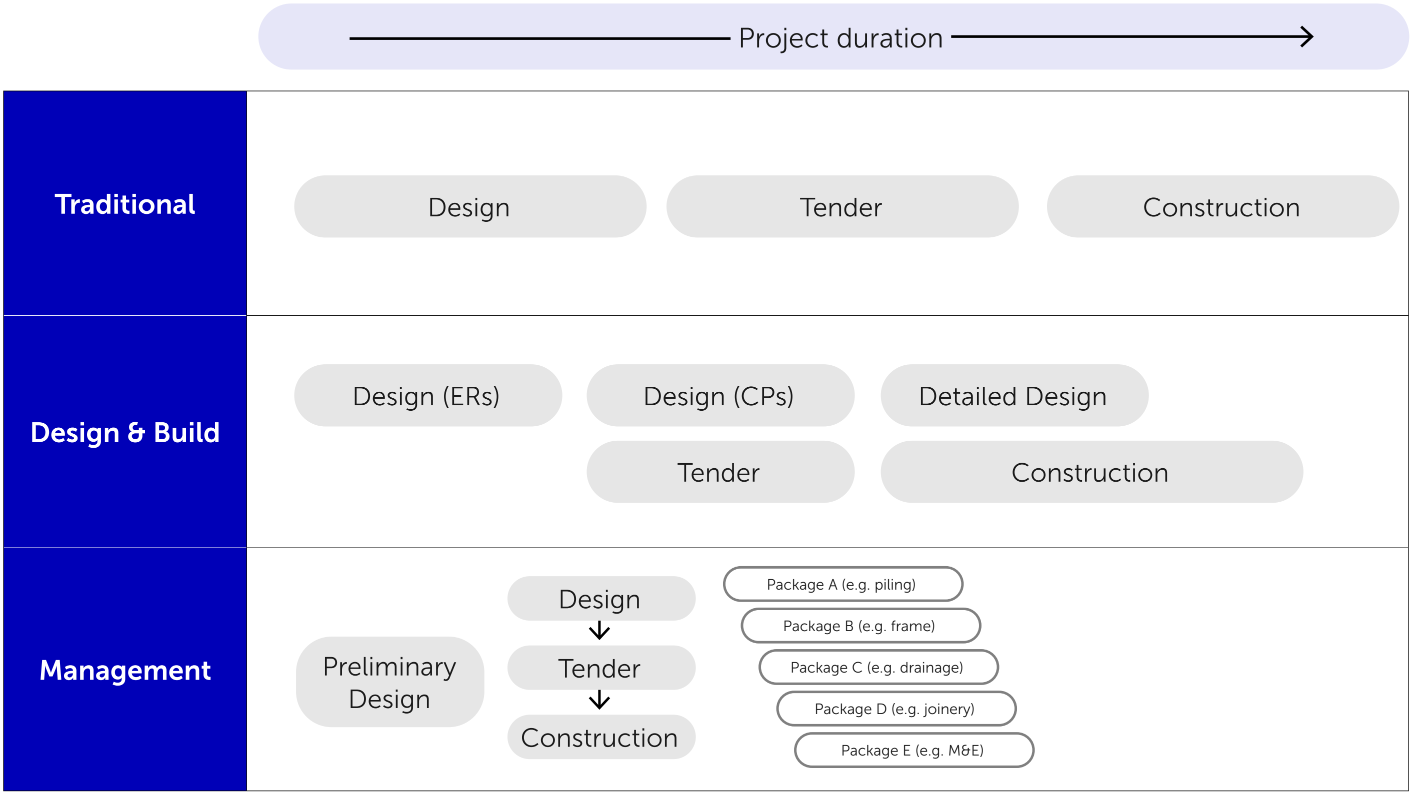
Advantages	Disadvantages
Cost certainty	No full quality certainty
Time certainty	Not as competitive
Buildability	

CM/MC/Self-procured



Advantages	Disadvantages
Flexibility	No single accountability
Quality control	No full time certainty
Shortest duration	No full cost certainty

Considering overall project duration, the procurement routes perform as below:



D.2.1.2 Building contracts

The function of the building contract is to provide agreed terms under which the borrower in relation to a development project (in this context, often termed the Employer) engages a contractor to undertake works on its behalf. The contract also provides a degree of protection in the form of rights, duties and obligations from each party to the other.

Building contracts can either follow standard forms or be bespoke with the former being the most common and preferable option, with bespoke amendments inserted to complement it.

The three most common contract suites are The Joint Contracts Tribunal (**JCT**), New Engineering Contract (**NEC**) and **FIDIC** (which is a contract template developed by the International Federation of Consulting Engineers). Some of the key points for each contract suite are listed in the table below:

JCT	1. Latest version is 2016 2. Arranged by procurement route 3. Most common in the UK 4. No heavy focus on the programme 5. Time and cost of variations is treated separately
NEC	1. Latest version is NEC4 2. Less common with smaller contractors and building projects 3. Time and cost of variations is combined 4. Contractor quotes for variations 5. Emphasis on programme which is a contract document 6. Overall, more proactive approach than JCT
FIDIC	1. Not familiar in the UK – not adequate case law 2. More relevant to large scale engineering projects

The most common form of contract would be a JCT contract especially when it comes to private sector led commercial and residential developments. The UK construction industry is far more familiar with JCT clauses and procedures, so a well drafted JCT contract can provide sufficient comfort to all stakeholders involved in a development project.

Bespoke contracts are not recommended since the contractors' unfamiliarity with their provisions can lead to excessive risk pricing as well as issues post contract.

Notwithstanding the familiar clauses of a standard JCT contract, a number of amendments are commonly negotiated to strengthen the Employer's position (and by extension that of the lenders financing the development):

1) **Payment terms:** by default, JCT provides a 14 day timescale for each interim payment to the contractor. This can be amended to 21 or even 28 days, facilitating the Employer's cashflow, 'de-risking' the payment in the sense that by the time the Employer pays for up to a certain value the contractor has further progressed. Additionally, amended payment terms allow more time for a lender to process drawdowns, as this process is not included in the JCT contract itself.

2) **Ground risk:** other than under the JCT design & build contract, JCT terms leave risks associated with the ground conditions of a site with the Employer. To mitigate any additional risks due to unforeseen ground conditions it is recommended that an additional clause is added to transfer the ground risk to the contractor. An explicit clause is recommended even for design & build contracts.

3) **Discrepancies in contract documents:** it is recommended that any discrepancies found in any of the contract documents (drawings, specification, pricing document etc.) are a contractor risk and the Employer should not be held liable for any of them.

4) **Collateral warranties:** relevant clauses should be amended to allow for payment to the contractor to be withheld where required collateral warranties are outstanding from the contractor or key sub-contractors.

5) **Programme:** since the JCT suite does not require a construction programme to be submitted on a regular basis, it is recommended that an amendment is introduced to oblige the contractor to regularly update and submit their construction programme so progress against contract dates can be adequately assessed as well as delays being proactively managed.

Overall, the contract particulars should be thoroughly reviewed, and cross referenced with all associated project documentation to ensure that the contract reflects all the project characteristics. In particular, the following checks should be undertaken:

- **Contract sum:** does this figure match with contract's pricing documents and the appraisal and financial model of the developer/borrower?
- **Programme:** do the start and completion dates tie up to the latest programme dates?
- **Insurances:** the contractor's insurance certificate needs to be obtained and its compliance should be checked against contract requirements (values and types of cover).

Any additional documents referenced or required in the contract (e.g. Employer's Requirements, performance bond, parent company guarantee etc.) should be obtained and reviewed.

D.2.1.3 Collateral warranties

Collateral warranties are agreements that provide redress for a third party (e.g. the lender) who is not party to the original contract between two other parties (e.g. the borrower and the contractor under the main JCT contract). Under this agreement the beneficiary of the warranty is able to enforce the terms of that contract should it step in to replace the original party. (Collateral warranties can also be used to give the Employer direct rights against sub-contractors.)

In the context of a development project, the lender has no contractual link with the main contractor hence there is no mechanism for the lender to enforce the terms of the contract or make a claim for potential losses. If, for example, the borrower defaults on the facility agreement the lender has no redress to the contractor to ensure that they complete the project. A collateral warranty will provide this mechanism and the lender will be able to replace the borrower under the contract and complete the works.

As a rule of thumb, a lender should require collateral warranties to be provided by the main contractor, the design consultants and sub-contractors with design responsibility or a specialist trade.

It should be noted that a collateral warranty cannot put the beneficiary in a better position than is as available under the underlying contract, so especially when it comes to design consultants' warranties, it is important to check that appropriate appointment documentation is in place between the consultants and the borrower.

It should also be noted that a collateral warranty provides no greater liability than originally agreed under the terms of the contract/appointment.

There are different form of collateral warranties including standard forms, but standard forms do not include lender specific provisions. When a building contract is to be amended and since the lender will likely have an input in this process, it is prudent for the proposed form of collateral warranty to also reflect the agreed amendments.

It is the general expectation for the following points to be addressed in a collateral warranty:

1) **Net contribution clause:** if parties responsible for the same loss or damage are all contractually liable to the other party to the contract, the liability of each party will be limited to the amount which would be apportioned to that party by a court. The lender may prefer joint and several liability to allow it to make a claim for 100% of the loss from various parties taking into consideration that a number of those may cease trading.

2) **Liability caps:** define the maximum amount that a party is liable for. The PI insurance provided by each party needs to match the level of the cap set in the warranty.

3) **Copyrights:** a copyright clause allows the Employer to use any design documents the sub-contractor/sub-consultant prepares. The licence should be royalty free, irrevocable, non-exclusive and include the right to assign.

4) **PI requirements:** collateral warranties always require the provision of PI insurances with adequate indemnity levels if a sub-contractor / sub-consultant has design responsibility. The collateral warranty will require that the PI insurance is kept in place for the full length of the warranty, 12 years if executed as a deed or 6 years if executed under hand.

D.2.1.4 Development security

Performance bond

A performance bond provides an Employer with a mechanism to recover some of the losses incurred if a contractor breaches the contract or becomes insolvent. Effectively, a surety (usually a bank or an insurance company) guarantees, for a premium, the contractor's performance. For example, if the contractor becomes insolvent the surety will pay a sum of money to the Employer to cover some of the losses that might be incurred to re-procure the works. A performance bond is for an amount up to ten per cent. of the original contract sum.

It should be noted that ultimately, the cost of the bond (premium) is passed to the Employer since this would be included within the contractor's preliminaries allowance.

Performance bonds may be conditional, on-demand or hybrid.

With a conditional bond, when a claim is made, the Employer must prove actual losses prior to the surety making a payment; monies cannot be recovered the moment the contractor becomes insolvent. The Employer should re-procure the works using their own funds prior to being able to recover losses at the back-end of the project. The lender should get comfort that there is either an adequate contingency allowance to offset re-procuring overspends or that the Borrower is able to fund any cost overruns directly via equity.

An on-demand bond allows a call to be made on the bond at will and does not require loss to be proven. It is considered a higher grade of performance bond and is preferable to a conditional bond, albeit there are usually significant cost implications if an on-demand bond is issued.

A hybrid bond can fall anywhere along the spectrum between a conditional bond and an on-demand bond. It will usually have conditions which must be satisfied before a claim is made, for example the provision of documentary evidence of breach of contract or losses likely to be suffered.

Finally, it is always worth undertaking due diligence on the bond's surety since the bond itself is only as secure as its underwriter.

Parent company guarantee

A parent company guarantee requires the parent company of a given contractor to step in and complete a project under the same terms and conditions of the building contract, should the contractor either breach the contract or become insolvent.

Usually, the guarantee will include clauses of no greater liability meaning the parent company will not be held liable for anything over and above the liability of its subsidiary under the building contract.

The apparent constraint with parent company guarantees is that not all contractors have parent companies and if they do they might just be holding companies rather than actual operating parent companies with the manpower and know-how to complete a project. As in the case of a performance bond, the contractors will price for the guarantee.

It is possible to have in place both a performance bond and a parent company guarantee providing enhanced security.

D.2.2 Construction programme

D.2.2.1 Programme description and specification

A detailed construction programme should be provided from the outset of a development project and monthly progress of the works should be monitored against this programme.

The construction programme should be provided in the format of a Gantt chart, prepared using specialist programming software, such as MS Project or Powerproject. The programme should also be fully linked to show key activity dependencies (including the critical path) and float, in order to assess the impact of delays in particular activities. The programme should be logical and sequenced in accordance with standard construction practice.

In simple terms, the critical path is the longest sequence of project activities which must be completed on time for the project to complete on the due date. An activity on the critical path cannot be started until its predecessor activity is complete; if it is delayed for a day, the entire project will be delayed for a day unless the activity following the delayed activity is completed a day earlier. Therefore, the identification and monitoring of the critical path is of paramount importance especially when assessing the consequential impact of delays.

It should be noted that the critical path of a construction project is not fixed but may change. If a specific activity not initially on the critical path was to be sufficiently delayed, it would become a critical activity.

Project delays or specific activity delays can be recovered by the presence of suitable float either at project level or at key activities level. Float can be defined as an amount of time allowed within a programme to compensate for any unforeseen delays encountered. Float is essential in time critical developments including pre-let buildings, hotels or student accommodation / build-to-rent (**BTR**) schemes. Terminal float of up to eight weeks between a building's practical completion and its occupation/operation date is recommended.

As previously mentioned, the programme dates should be cross referenced with the building contract's dates since the latter is what takes precedence since this what a contractor commits to. In addition to the building contract the following checks should also be performed to ensure consistency against the programme dates:

- Tenant/occupier handover / long stop dates
- Expected income/revenue dates in the Borrower's appraisal/cashflow
- Phased handover / sectional completion with expected occupation dates
- Third party fit out works – e.g. retail units
- Lease/sale agreements
- Repayment and longstop dates in the loan facility
- Timing of conditions precedent and subsequent in the loan facility
- Key design dates / statutory approvals
- Any key third party / sub-contractor /supplier dates that will affect the construction programme – remediation works, asbestos removal, long lead-in times, utility services, easements etc.

Finally, the overall duration of a scheme as well as individual durations of key activities should be benchmarked against developments of similar size and nature to provide comfort over the feasibility of the proposed completion dates. Monthly progress should be closely monitored, and key programme risks identified and reported to all interested parties.

D.2.2.2 Programme Risks

Each project attracts its own programme risks depending on the nature of the building to be developed as well as site and location constraints. Professional advice should be obtained for project specific risks and the measures for mitigating such risks. Certain standard risks should always be assessed when considering a development project. These are listed below:

- Unforeseen site conditions affecting progress (asbestos, site contamination, existing building condition, etc.)
- Resource availability to progress activities in parallel
- Procurement and delivery of key materials
- Access to and egress from the site
- Compliance with statutory requirements that could affect progress (e.g. discharge of planning conditions or other statutory covenants)
- Mobility of resources in order to progress different trades concurrently
- Inclement weather.

It should not be expected that any of the above risks threaten the feasibility of a development since an experienced contractor and developer/borrower should be able to foresee such risks and mitigate them from the outset and on an ongoing basis.

D.2.3 Approvals and consents

D.2.3.1 Planning approvals

Statutory approval or planning permission is required for all material developments (including initial construction and subsequent alterations works) and/or changes of use affecting a property. In some cases, if a building is listed as being of special architectural or historical interest, or is located in an officially designated and specially protected planning area (for example a Conservation Area, Area of Outstanding Natural Beauty or a National Park), additional consents may be required.

Planning is therefore an important factor influencing the value of a property and, as part of a due diligence exercise, it is important to:

- determine what (and to what extent) planning factors affect the development, redevelopment and/or change of use potential of the property;
- verify that all requisite consents have been obtained and that no changes have occurred which could affect the validity of these and/or require further approvals;
- check that all conditions to which any such consent is granted have been complied with (breach of these could lead to an order to remove any unauthorised works and and/or cease any unauthorised use).

Enquiries in this respect will usually be made of the competent authority (normally the local council, although specific statutory bodies may deal with major specific infrastructure projects) as part of the legal report on title. A valuer will also normally make basic checks in this respect but these will only identify what permissions are required and/or issued and whether any notice of breach or enforcement action has been served and will not confirm, for example, whether developments have been completed in accordance with approved plans and/or that the actual use complies with the authorised use.

Additional investigations are likely to be needed where a property is being, or is proposed to be, redeveloped. In such a case a report from a specialist planning consultant should be undertaken to ascertain what new permissions are needed, how likely it is these can be obtained and what conditions the permissions are likely to be subject to. A full survey and physical inspection may also be appropriate and, if a major planning application is anticipated, this may advise on the likely issues and objections as well as timing and budget projections. Any such report or survey should consider the following:

- emerging planning policy and guidance and the timescales for public consultation to allow for making representations;
- details of planning applications relevant to the property (whether granted, refused or withdrawn);
- details of planning appeals relevant to the property (whether allowed or dismissed);
- conditions attached to relevant permissions and details of obligations in any legal agreement with any planning or other statutory authority;
- any enforcement action;
- any nearby road or other transport proposals; and
- whether the property is listed, in a Conservation Area or other specially protected planning area, or subject to any Tree Preservation Orders.

It is important, if a major development or change of use for a property is expected, that all consultants preparing due diligence reports are informed when initially instructed as this will have a major impact on the extent and nature of the diligence undertaken.

In the construction context, there a number of items to be considered when reviewing planning permissions and other statutory consents. These items are listed below:

1) **Planning conditions:** the majority of planning permissions are subject to conditions which are either 'pre-commencement' (required to be discharged prior to commencement on site or of a specific activity), or which are required to be satisfied prior to the occupation of the building. Others may involve compliance statements which do not require formal discharge, but must be complied with during construction and/or following completion of the works. Conditions must be discharged in a timely manner and the progress of the contractor and/or developer/borrower in so doing should be monitored. It is recommended that the discharge of all pre-commencement conditions is a condition precedent to drawdown of development funds to minimise the risk that works executed on site may be abortive, leading to further time and cost implications. Finally, suitable provisions should be included in the scope of works to address the planning permission's conditions.

2) **Approved drawings:** for similar reasons to the ones stated above it should be verified that the developer and its appointed contractor intend to build the consented scheme and the development is undertaken strictly in accordance with the approved drawings. To that end, the contract's construction drawings must be cross referenced with the approved drawings in the planning permission. Any internal alterations or other amendments to the consented scheme should be approved by the local planning authority following the submission of an application for either a Non-Material Amendment (Section 96a application) or a Minor Material Amendment (Section 73 application).

3) **Unilateral undertakings / financial contributions:** as mentioned earlier in this guide, if a scheme is liable for CIL or Section 106 financial contributions, the relevant documentation should be reviewed, and adequate allowances should be included in the scheme's appraisal. Furthermore, the timings for the required payments must be known. Finally, on Section 106, it should be noted that non-financial requirements may also apply, and these should be addressed in the agreed timelines. Interrogation of the scheme appraisal should establish whether any requirements require expenditure, in which case appropriate allowances should be made.

It is a common mistake for a sufficient amount to be budgeted but no indexation allowance to be included. Payments are typically linked to the Retail Price Index from the date of the agreement to the date of its implementation (which may take years), so an indexation allowance should be budgeted.

D.2.3.2 Consents

In addition to the planning permission and the unilateral undertakings there are other consents that may be relevant. The salient points of these consents are briefly described below:

1) Other statutory agreements:

These are mainly concerned with the adoption and/or improvement of public highways.

i. Section 278 (Highways Act 1980) allows a developer/borrower to carry out works to the public highway when a planning permission has been granted for a development that requires improvements or changes to public highways. Such agreement will include details of who will design and manage the works, the programme for the works, provision for inspection and certification of the works as well as any associated costs. It should be confirmed that suitable allowances have been made within the scheme's appraisal or within the contract sum if the contractor is to undertake these works.

ii. Section 38 (Highways Act 1980) provides that when planning consent has been granted for a new development, developers may ask the highway authority to 'adopt' new roads that have been constructed as part of the development, along with associated infrastructure such as drains, lighting and supporting structures. Adoption means the highway authority agrees to undertake maintenance of the road from an agreed date at the public expense. If this is applicable to a development, it should be in place prior to completion of a scheme since if the obligation to maintain the highway lies with the developer/borrower this might affect the asset's valuation due to annual costs associated with the maintenance.

iii. Section 184 (Highways Act 1980) provides that a developer/borrower will need to enter into an agreement for the construction of, or alterations to, any site access. It relates specifically to access where the work being done is all that is required to enable the development, or if the work needs to be done before the main works can proceed under a Section 38 agreement (adoption of highways) or a section 278 agreement (allowing a developer to carry out works to a public highway).

iv. Section 104 (Water Industry Act 1991) provides that a developer/borrower will need to enter into an agreement for the adoption of newly constructed sewers/drainage systems that may form part of the agreement but will need to be adopted by the relevant authorities thereafter.

2) Rights of light:

A right of light gives a property owner (a **Dominant Owner**) the legal right to receive light through defined apertures in buildings on their land. The burdened landowner (a **Servient Owner**) cannot substantially interrupt this (for example by erecting a building in a way that blocks the light) without the consent of the Dominant Owner, who is prima facie entitled to an injunction to protect its right. The Dominant Owner may have express rights of light (set out in an agreement between the Dominant Owner and the Servient Owner) or, more commonly, undocumented prescriptive rights (acquired by 20 years' enjoyment of light over land owned by the Servient Owner). An interference with a right of light can be acceptable, provided that it does not itself amount to a nuisance.

Rights of light are of particular concern in the case of development land and it is vital to a developer and its lenders that due diligence is carried out to identify potential risks since a Dominant Owner with rights of light over the relevant property could prevent construction or, in some circumstances, require demolition of the infringing part of a building. The court in recent years has been more prepared to grant injunctions restraining development but, even if it does not do so, can award damages (which range from 5% to 50% of development profit) arising from any new development which interferes with the Dominant Owner's rights. This has led to rights of light being elevated towards the top of a developer's concerns, and compensation budgets increasing as Dominant Owners have become more aware of the value of their rights.

It follows that the resolution strategy of such matters must be established from the outset of a development project since if a deed of release is not agreed (in case an insurance policy does not suffice) the design and scope of a building might need to change. Specialist advise from a qualified surveyor is required to ascertain a suitable resolution strategy while all relevant deeds of release should be in place before construction commences. All compensation allowances and associated fees should be included in the scheme's appraisal. Should an insurance policy be obtained it should be held in perpetuity and the indemnity level should be in line with the level of damages anticipated as noted within the rights of light surveyor's report.

A report on or certificate of title for the property should identify whether there are any express agreements registered against the title to the property, although beyond such registered agreements rights of light are usually carved out of the scope of reports and certificates on title and would usually be investigated by specialist rights of light surveyors. A specialist survey may be required to identify prescriptive rights and the service of any Light Obstruction Notices (local land charges registered to protect rights in favour of neighbouring undeveloped land) in relation to the property. Specialist surveyors can provide advice as to what such rights may subsist and/or whether specific designs will amount to an interference.

3) Party wall issues:

The Party Wall etc. Act 1996 is an enabling Act, in so far as it grants the owner of a property the legal right to undertake certain works that might otherwise constitute trespass or nuisance. However, it also seeks to protect the interests of adjoining owners from any potentially adverse effects that such works might have by imposing a requirement that all adjoining owners be given prior notice of them. Specifically, such notice must be served where the owner of a property (known as 'the building owner') intends to undertake any construction work described in Sections 1, 2 and 6 of the Act. Section 1 applies where it is proposed to erect a new wall at a boundary that is not already built on. Section 2 concerns existing party structures, which include party walls, floors and partitions (that separate buildings or parts of buildings) and party fence walls. Finally, Section 6 can apply to excavations up to 6m away from a building or structure on neighbouring land, subject to depth criteria which the Act sets out. The developer/borrower should hire a specialist surveyor to serve the required notices and agree the respective party wall awards which should be in place before relevant works commence. The agreed awards should be reviewed in the context of the proposed scope of works. As mentioned at C.6.1, fifth bullet point, reasonable allowances should be included in the scheme's development appraisal to cover the party wall surveyor's fees and any required rectification costs.

4) Building control:

Building control is the process of ensuring that a building under development complies with Building Regulations. Building Regulations are effectively the building code in the UK, setting minimum standards and performance criteria that new buildings must meet. The developer/borrower shall appoint a building control approved inspector who must, prior to the development commencing, submit an Initial Notice to the Local Authority, to check the details and register the work there for future land searches. The Local Authority has 5 working days to reject the notice if the details are found to be incorrect. If there are no objections to the initial notice within this time, the works can then commence on site. It is recommended that a plans certificate is also provided from the outset, to ensure that the plans and details provided have been checked and accepted as compliant with Building Regulations. All the information required must be submitted to the approved inspector and all the necessary consultations completed satisfactorily before he can issue such a certificate. This is particularly relevant when it comes to commercial developments where a consultation with the Fire Authority is mandatory under the Regulatory Reform (Fire Safety) Order 2005. Once works commence, stage inspections will be undertaken by the approved inspector to certify that works are progressing in compliance with Building Regulations and the approved plans. Inspection reports should be provided and reviewed to ascertain that no adverse comments are being made. Any rectification actions noted in the reports should be taken accordingly and the lender should monitor this process. When the building reaches completion, a final certificate will be provided, and the lender should get a copy.

5) Health & safety (H&S):

CDM regulations are concerned with health and safety matters in construction projects. CDM regulations make the developer/borrower and all the members of the design team 'designers' which have to actively identify and manage risks on H&S both in construction and during the design stage. The latest changes introduce the concept of a "principal designer" who may (but need not) be the lead designer and must be provided with the authority to influence design from a H&S perspective and provide pre-construction information to the principal contractor. Under the CDM regulations, the Health and Safety Executive (**HSE**) must be notified of any project defined as construction under the regulations where the construction work is likely to last longer than 30 working days and either have more than 20 workers working simultaneously at any point in the project, or exceed 500 person-days. This is done via an F10 notification form which should be received and reviewed to ensure that the project details provided are consistent with the rest of development documentation. Finally, before the construction phase begins, the CDM regulations require the principal contractor to populate the construction H&S plan, which records arrangements for managing significant H&S risks associated with the construction of the project and is the basis for communicating those arrangements to those involved in the construction phase. Similarly with the F10, this should be provided and reviewed. Finally, the lender should monitor the contractor's H&S compliance during the course of the works.

6) Building warranty:

A final consent that should be in place especially for new-build developments is a building warranty for latent defects. This is particularly relevant to residential developments as prospective buyers would need one to obtain a mortgage. The provision of a building warranty is therefore likely to be critical for an exit strategy of the developer/borrower for a speculative residential development. This is also relevant to commercial development where a warranty provides comfort both to the building owner as well as prospective leaseholders. A suitable warranty provider should be selected and the scheme should be registered from the outset. It is of paramount importance that the building warranty provider is UK Finance (the successor body to the Council of Mortgage Lenders) since this means that the warranty is accepted by most mortgage providers. Similar to building control inspections, the building warranty provider will undertake inspections (unless it is willing to rely on the inspections undertaken by Building Control. In any event, the lender should monitor these inspections and ensure compliance with the provider's policy. Once the development is complete the building warranty will be provided.

D.2.4 Construction / Development Surveys

In addition to the surveys and reports covered elsewhere in this guide, there are additional surveys that might be required for a development project. There is not a finite list of surveys that would be required, and each project requirement should be examined on a case by case basis and in conjunction with the scheme's particular features, planning permission and other statutory requirements. For reference some of the surveys that might be expected are listed below along with a brief description of their scope:

1) **Ground investigation survey:** this is concerned with the ground conditions of a specific site including contamination as well as recommendations with regards to the substructure design.

2) **Flood risk assessment:** this should include a full assessment of a building's flood risk as well as recommendations on how this can be minimised.

3) **Structural appraisal / structural integrity:** this is mainly concerned with existing buildings and the impact of an extension/change of use to their structural integrity.

4) **Asbestos survey:** again, this is for existing buildings where refurbishment works are to take place. The survey should identify where asbestos is present and the most appropriate way of disposal. It is recommended that clean air certificates are provided as conditions precedent to drawdown in relevant cases.

5) **Archaeological survey:** this is concerned with the archaeological interest of a site and how a proposed development may impact it, and/or what measures should be taken to preserve archaeological features or finds.

6) **Noise assessment:** this is usually a planning requirement and is concerned with the notice impact of a completed development as well as providing design recommendations on how this impact can be kept to a minimum.

7) **Transport assessment:** this is concerned with the impact of a completed development on the transportation network in a building's vicinity.

8) **BREEAM:** BREEAM is the Building Research Establishment Environmental Assessment Method and is an

established method of assessing, rating, and certifying the sustainability of buildings. A specific BREEAM rating can be part of a planning consent and the lender should monitor the compliance by the developer/borrower with the BREEAM scoring requirements.

9) **Tree survey / arboricultural surveys:** this is mainly applicable to greenfield sites, where such a survey ascertains the impact of the proposed building on the surrounding ecosystem as well as recommending risk mitigation measures.

All surveys should be reviewed and cross referenced against a scheme's proposed design and scope to ensure compliance. During the construction phase the implementation of any recommendations should be monitored.

Finally, it is recommended that reliance is obtained on any surveys of significant findings that heavily impact the scheme's scope and subsequent development decisions e.g. a right of light report. Similarly, the developer/borrower should seek reliance on reports that are not addressed to him directly (see F).

D.3 Additional Reports

The following additional reports will not be necessary or even desirable in all cases but may be recommended as a result of the findings of one or more of the principal reports and may also be appropriate for particular types of property, transaction and/or for the proposed property use/development. A number of these reports may also fall under the remit of the report on or certificate of title (see D.1.2).

D.3.1 Utilities (gas, electricity, telecommunications etc.)

A new development will need to be connected with all major utilities to be fit for occupation and use and, even where the building is already constructed and/or occupied, additional or new connections may be required to suit the requirements of a new tenant or buyer or simply to keep pace with changes to technology.

Specialist reports may therefore be advisable to check what services are available, whether these have sufficient capacity (taking into account expected additional usage and demand) and what works are required to connect to the mains supply. Planning or construction matters and/or legal issues requiring an easement, licence or wayleave may also arise where the supply crosses other land.

D.3.2 Deleterious Materials

There is no definitive list of such materials, but asbestos, high alumina cement, wood wool slabs used as permanent formwork, concrete additives containing calcium chloride, calcium silicate bricks, products or materials containing urea formaldehyde foam and lead based paint are all normally considered deleterious. The most common are asbestos and lead based paint.

Asbestos

Most buildings should have an asbestos management plan in place, listing materials sampled for asbestos and asbestos containing material, which should be clearly labelled. The different types of asbestos survey are as follows:

(a) **Management survey:** legally required during the normal occupation and use of premises – where the premises are simple and straightforward, such a survey can be undertaken to ensure that:

(i) nobody is harmed by the continuing presence of asbestos materials in the premises or equipment;

(ii) any asbestos present remains in good condition; and

(iii) nobody disturbs it accidentally

The Survey must locate asbestos that could be damaged or disturbed by normal activities, foreseeable maintenance, or by installing new equipment. It involves minor intrusion and asbestos disturbance to make a materials assessment (this shows the ability of asbestos, if disturbed, to release fibres into the air and guides the client, for example in prioritising any remedial work).

(b) **Refurbishment/demolition survey:** required where premises need upgrading, refurbishment or demolition - normally, a surveyor is needed for this type of survey, which does not need a record of the current condition but aims to ensure that:

(i) nobody will be harmed by work on asbestos containing materials in the premises or equipment; and

(ii) such work will be done by the right contractor in the right way.

The Survey must locate and identify all asbestos materials before any structural work involving destructive inspection and asbestos disturbance begins at a stated location or on stated equipment at the property. The area surveyed must be vacated, and certified as fit for reoccupation after the survey.

Lead

Risks posed by lead are only realised if lead can be ingested, inhaled or absorbed, but can be present if there are lead pipes in buildings or if people are in contact with dust or flaking paint. There are no specific UK guidelines for lead paint sampling but a similar approach can be taken to the asbestos surveys, for example sampling and analysis of paint or dust by using a portable XRF metals analyser. The risk posed by lead paint should be assessed using the exposure potential and the lead concentrations of the paint.

D.3.3 Mining (coal, tin, lead, salt/brine, china clay etc.)

Historical mining activity may physically affect a property, causing ground movement as the workings collapse and the ground consolidates. In addition, the presence of shafts and adits may form a preferential pathway for the migration of potentially explosive gas.

An initial mining assessment will be undertaken during a standard environmental due diligence process although, if the site is located in a high-risk area, further survey may be required. This can include evaluation of data held by the Coal Authority, such as the depth of mine workings and when they were abandoned, from which it is usually possible to determine if there is a material risk to a project. Occasionally, if there are shallow workings or on site shafts, some exploratory borehole assessment may be needed.

D.3.4 Unexploded Ordnance

Some properties may have been subject to bombing during World War II. A basic ordnance assessment report can be undertaken as part of an environmental survey, however it is more common to undertake this at development sites where deep excavation or piling may be required. The report will assign a risk level to the site.

D.3.5 Flooding

Basic flood risk assessment is usually covered in an environmental diligence report and takes the form of review of Environment Agency flood risk maps and information gathered from interviews with site staff. The form of such an assessment varies depending on whether it is an existing building (in which case a practitioner would typically look at whether a site has actually flooded) or a new development site (when a full assessment is required).

D.3.6 Occupational Requirements

A valuation report will generally assume a building complies with current regulations but a lender or investor (especially if the property is new, vacant, or to be developed) may wish to obtain a specialist report to verify this since, if a building does not comply, additional works and expense may be required to attract a tenant/user. A building occupier will also wish to be satisfied that such is fit for its intended purpose and use, and to know what alterations may be required in order to comply with any relevant statutory requirements.

The principal responsibility for compliance is usually on the actual user or tenant, but the main areas of interest are:

(a) **Health and Safety:** an owner/user must provide a safe and secure working environment for occupiers and employees – the requirements vary depending upon the type of premises and use but usually a formal assessment of inherent risks should be carried out and steps taken (usually involving additional works) to mitigate these.

(b) **Disability Discrimination:** a building open to the public or to which the public are generally admitted must be constructed/fitted out so as to accommodate special requirements of disabled users or visitors.

(c) **Fire Precautions:** there must be adequate means of leaving the premises in case of emergency (this usually requires a second escape route if the main exit is blocked and safe storage facilities for hazardous or inflammable materials).

(d) **Planning/Building Regulations:** alterations and works must comply with statutory planning and building regulations (see generally D.2.3).

(e) **Energy Performance:** as also mentioned at D.1.3, most buildings now require an Energy Performance Certificate or EPC (see D.3.9) offering an assessment of the efficiency of the building in consuming gas, electricity and other energy sources and recommendations for improving this.

(f) **Utility Supplies:** a user/occupier will want to ensure that power supplies and telecommunications services are adequate, available and installable without having to undertake works and/or obtain easements or licences over neighbouring properties.

D.3.7 Infrastructure (railway, highway, waterways etc.)

Additional, specialised, enquiries should be made where a property is located close to an actual or proposed major national infrastructure development, for example a major waterway, port, power station, new road or railway. Many such projects are subject to special planning (zoning) approval, compulsory purchase (condemnation) and/or compensation schemes, although the final consequences and/or impact on value may not be immediately apparent.

D.3.8 Capital Allowances

Equipment installed on property may be eligible for tax relief known as capital allowances. The capital allowance rules are complex, and can change frequently. Consequently, where an investor or lender believes that capital allowances may have a material impact on the value of a property or (post-tax) future cashflows from the property, a specialist report should be commissioned. This should, to the extent possible, identify any equipment or buildings subject to such allowances, the amount of these and who is able to benefit from them. In some cases an election can be made for the benefit of capital allowances associated with expenditure incurred by a seller either to pass to a buyer, or to be retained by the seller.

D.3.9 Energy efficiency/performance

All buildings are now subject to energy certification schemes and compulsory inspections for equipment such as boilers and air-conditioners (new buildings will be required to comply with higher standards in this respect and in the United Kingdom there are legal restrictions on letting properties to tenants with an energy efficiency below a certain level). A consequence of these is that (as also mentioned at D.1.3) an Energy Performance Certificate must be made available to new tenants and purchasers of property. Generally, these can only be issued by competent, licensed persons and must be commissioned before beginning to market a property for sale.

Policy in this area is developing rapidly, with current UK minimum energy efficiency standards due to affect more buildings from 2023 and to require a higher minimum rating by 2027 and/or 2030; there is also the prospect of mandatory performance-based ratings being introduced for larger commercial buildings. Lenders are also increasingly likely to need to monitor and report climate-related risks in their collateral base to regulators under national and/or EU rules.

It is noted that buildings with outstanding environmental criteria and 'Smart' buildings can achieve above average market valuations and rents. If this is the case, this area should receive additional review within the building and mechanical and electrical review.

Additional Considerations

A thorough due diligence of legal requirements such as KYC, ownership structure, asset, tax and financial projections is a fundamental part of the underwriting and lending process. It is, however, only one of the cogs in the whole credit decision process.

The decision to proceed with a specific lending opportunity is seldom based on a single aspect of the transaction; it is normally the positive conclusion of a number of investigations on the merits of the transaction, as well as the strategic alignment of the opportunity with a lender's credit and market risk appetite. Rarely is any of the credit aspects in isolation enough to support and to justify the origination of a loan, but each of them could in their own right be enough to justify a decision not to proceed.

Beyond the credit due diligence on the sponsor, the ownership structure, the quality of the underlying collateral and the sustainability of the income streams, a number of considerations, which are less related to the deal itself but more idiosyncratic to the lender, will also play an important part in the decision: examples, briefly discussed below, include strategic, market risk-related, regulatory and ethical considerations.

- **Strategic: l**ending institutions spend a great amount of time and resources cultivating client relationships and when two opportunities arise, both of equal merit from a credit standpoint, a lender will naturally gravitate towards the opportunity where an institutional relationship already exists.
- **Market risk** and **Pricing** are also fundamental considerations, with the latter, more often than not, the primary focus of the underlying borrower as well. For a lender whose funding strategy may rely on distribution of risk (whether through the loan syndication market, the securitisation market or otherwise), market risk is of paramount concern as one of the lessons from the 2008 Global Financial Crisis was that market liquidity can vanish instantly. Decisionmakers will, today, carefully assess what they believe are market-clearing loan margins for syndication/distribution and how much of a spread buffer a specific transaction has relative to that clearing price. Such a buffer provides a degree of comfort on how likely it is that the loan can still be distributed should the market turn and spreads widen.

  Linked to market risk is the time an institution will give itself to distribute risk. Financial institutions are under an obligation to mark-to-market assets which they intend to distribute. The longer it gives itself to sell, the longer it remains exposed to possible adverse market changes and therefore to the possibility of having to mark down the value of a credit below. With this in mind, the emphasis is increasingly on identifying the preferred distribution channel prior to originating a loan.

- **Regulatory** and **Profitability:** the rules relating to risk weighting and regulatory capital have undergone significant changes since the GFC, with different kinds of lending institution now subject to a range of quite different regulatory capital frameworks. For banks and insurance firms, regulatory capital may be a decisive factor in whether a particular loan can be written on a sufficiently profitable basis (although the distribution strategy will also be relevant here).

  One of the outcomes of the due diligence process is the ability to benchmark the opportunity compared to other loans and/or to lending criteria. This may take the form of a scorecard or memo which contains some high-level loan metrics such as country exposure/asset location, governing law, LTV, DSCR, Debt Yield, WALT, collateral type (e.g. office, resi, retail, etc.) and collateral quality (e.g. core, prime, secondary). These metrics can be a combination of quantitative and qualitative assessments of the loan and will often dictate how much regulatory capital (the amount of capital a bank or other financial institution has to hold as required by its financial regulator) is needed.

  The amount of capital an institution must hold will have a direct impact on the profitability of the lending opportunity. The more regulatory capital the lender must hold, the more expensive it is and the higher loan spreads will have to be in order to achieve any return hurdles that the bank (or the relevant business unit) has set itself. Very broadly speaking (the rules were not written by real estate experts and are not perfect), that process should ensure that the greater the level of perceived risk, the greater the regulatory capital and therefore the higher the margin that the bank should charge in order to pursue that opportunity.
- **Ethical:** finally, one bundle of considerations that is increasingly at the forefront when it comes to doing business is environmental, social and corporate governance (**ESG**). ESG encompasses the three factors used to measure sustainability and ethical impact of an investment in a company or business. Environmental and socially responsible investing is not new and has been practised for over a half a century, although investment volumes in the 1960s and 1970s were low, primarily constrained by a belief that ethically directed investments were by their nature likely to reduce financial returns. Fast forward to today and ESG has become a prominent criterion for most global financial organisations (and perhaps most notably in the real estate context for the pension funds and insurance firms that allocate capital to real estate equity and debt strategies). The evidence of a correlation between stronger ESG characteristics and better financial performance is becoming greater.

  In the real estate sector, this translates into greater emphasis on environmentally friendly buildings/projects, as well as the role of real estate as built environment servicing local communities and 'real economy' businesses. Often forgotten, real estate continues to contribute a significant percentage of annual global greenhouse gas emissions and a drive towards greener buildings is noticeable. Sponsors' business plans are reviewed with a more critical eye, particularly when it comes to construction and/or repositioning of assets which may involve the disruption or relocation of local business or communities.

The due diligence on the credit aspects of a transaction continues to underpin lending decisions. But it is by no means everything, and lending institutions will continue to broaden the scope of due diligence depending on specific requirements as well as developing industry-wide trends.


INSURANCE
ISSUES

E. INSURANCE ISSUES

E.1 Insurance Due Diligence

The purpose of insurance due diligence is to consider:

- past risk exposures, coverage and claims experience;
- the adequacy of the current insurance policies currently in place or proposed by the borrower and compliance with any obligations imposed by the lender, including a comparison with best practice; and
- to assess if there are any foreseeable factors that might affect the availability or cost of insurance which may affect the viability of the transaction.

An analysis of past claims, for both property damage and liability, can identify trends that might influence lending decisions. Further, where an insurance company pays a claim, it has the right of subrogation which enables it step into the insured's shoes and attempt to recover what has paid out from those who have created the loss. Care should be taken not to prejudice this right when entering into agreements with the vendor or other parties.

The borrower should be asked about any outstanding insurer required risk improvement measures and if there is any reason why the current insurance may not be maintained in the future (if notice of cancellation has already been given by its insurers new cover after completion may be difficult or impossible). All of this should be done, and the adequacy of the cover measured, against the requirements of any purchase, loan or other documents to check that all relevant obligations are met (required insurance can take several weeks to arrange, due to the amount of diligence that will need to be undertaken).

General Provisions

Copies of the actual policy documents with full schedules, reinstatement valuations, up-to-date endorsements and accurate and complete rent schedules should be vetted, as documents prepared by other parties cannot be relied upon (especially where a third party is arranging the cover). Asset or property management agreements should also be checked as these may include a responsibility for arranging or managing insurance (these are regulated activities since the introduction of the Insurance Mediation Directive in 2005 and it is important to ensure that any person responsible for such is registered with the appropriate regulator).

An existing insurance policy may remain in place until (or even after) completion, although this is unsatisfactory for the following reasons:

- the risk of damage passes to the buyer on exchange of contracts, and, although the buyer's interest can be noted, the seller retains control over the insurance and claims;
- a breach of policy conditions or insurer requirements by the seller or another party (such as a tenant) may prejudice the cover;
- the policy can be avoided if material facts have not been disclosed to the insurer;
- the property may be under-insured and the proceeds insufficient to reinstate the damage or compensate for the loss.

It can therefore be better to arrange separate cover to protect the borrower and funder, as the seller's insurable interest will fall away once they have sold the property. A careful review of the current premium costs should also be undertaken to ascertain:

- whether the premiums are in line with market rates or if a change of owner and insurer will trigger an increase (causing friction with tenant);
- any 'behind the scenes' arrangements with the broker or insurers that might cause future problems;
- any long term agreements (e.g. obligations to maintain cover with the existing insurers for a minimum period) – these can be beneficial, keeping costs stable but need to be understood as breaking them can be expensive.

A funder should also check whether the security assets are covered by title insurance, either when the loan is originated, or if a subsequent security review is undertaken.

Types of Insurance

As well as standard buildings insurance cover, consideration should be given as to whether cover for specific additional risks is needed, for example:

(a) **Public Liability Insurance / Property Owners Liability Insurance:** protects against third party claims arising out of the ownership and management of the property – often included as a separate section in a property owner's insurance policy but an increased limit of liability may be needed. The cover is provided on a claims occurring basis, i.e. the applicable policy is the one in force when the incident happens, not the one in force when the occurrence is notified, and it is therefore important to check there is a full insurance history during the period for which the buyer assumes liability.

(b) **Environmental risk insurance:** covers liability arising from pollution and/or clean-up costs which are usually excluded from standard public liability insurance (see E.2).

(c) **Professional Indemnity (PI) Insurance:** any professional (e.g. a valuer, solicitor or other professional or report provider) engaged in connection with a property should be required to take out insurance (and provide evidence of cover) against future claims (it is important to remember, however, that this is primarily to protect the negligent professional – not to pay claims to the party who has suffered loss). Professional Indemnity should also be requested for members of the design team in development contracts. It is worth noting that not all PI insurance policies include fidelity insurance (covering the risk of theft as distinct from negligence); policies should be reviewed to ensure this is covered if it is anticipated that the relevant professional will manage third party money.

(d) **Latent Defects Insurance:** covers damage by unforeseen risks (e.g. rectification of a structural defect) which is excluded in a buildings insurance policies and independent of the establishment of liability. Cover should be in force at practical completion before which the insurers will carry out a series of technical audits to ensure that the contractor follows the approved method of work and that the materials used are as described in the contract documents. If cover is not in place, this can sometimes be arranged post practical completion of a development provided there is a satisfactory technical report by the underwriter's engineers although placing this cover retrospectively can be extremely costly.

(e) **Warranty and Indemnity Insurance:** a sale agreement often imposes warranties and indemnities upon the seller, but, if these cannot be given or there are concerns about the warrantor's ability to meet any claim, insurance may give comfort to the buyer and funder. The policy, whether seller-side or buyer-side, will indemnify the insured for loss resulting from a breach of warranty or tax deed/ covenant in a Sale and Purchase Agreement. A seller-side policy covers the seller for its own innocent misrepresentations; a buyer-side policy covers the buyer against the seller's misrepresentations (innocent or otherwise). The buyer claims directly against the insurance policy and does not have to seek recourse against the seller.

(f) **Defective Title Insurance:** insures a defect in the legal title to the property (e.g. an old restrictive covenant prohibiting the current or proposed use) – in some cases this may also be offered in place of the usual legal due diligence reports (see E.2).

(g) **Contractors All Risks Insurance:** Contractors All Risks (**CAR**) insurance is a non-standard insurance policy that provides coverage for property damage and third-party injury or damage claims, the two primary types of risks on construction projects. CAR insurance bridges these risks into a common policy designed to cover the gap between exclusions that would otherwise exist if using separate policies. Typically, both contractor and employer jointly take out CAR insurance policies, with other parties such as funders having the option of being named on the policy. Because multiple parties are included in the policy, they each retain the right to file a claim against the insurer, although all parties have the duty of informing the insurer of any injuries and damages that may result in a claim. The aim of a CAR insurance policy is to ensure all parties are covered on a project, regardless of the type of damage to the property or who caused the damage.

(h) **Contractors All Risks Insurance extensions:** Additional covers are available as extensions to CAR policies to cover supplementary risks. Delay in Start Up (**DSU**) also known as Advanced Loss of Profits (**ALOP**) or Loss of Anticipated Revenue (**LOAR**) insures project owners for the financial consequences of a delay to project completion arising from an insured physical damage event. The cover is best purchased with the CAR policy covering physical loss or damage to the project. Non-negligent Liability may also be required under the terms of the building contract. This policy is purchased to provide protection against the employer's liability for expense, liability, loss, claims or proceedings that arise due to non-negligent damage to surrounding property.

Lender Requirements

A lender will have specific insurance requirements which may necessitate amended or replacement insurance cover. The insurance obligations are set out in the agreement in a separate section. Whilst the majority of the requirements are commonplace, care should be taken to ensure that the potential risks associated with the specifics of the transaction are catered for.

The key questions for lenders are:

- Is the Property insured?
- Is it covered correctly?
- Do the policies meet the terms of the loan agreement insurance clause?
- Will the policy respond in the event of a loss?

Key to the insurance contract is establishing insurable interest – does the borrower or SPV have this and does the insurance policy cover the borrower entity and their property?

If the property is not insured for its correct reinstatement value, insurers may apply average. If insurers apply average any claims settlements will be reduced to account for the underinsurance.

The loan agreement will usually require insurance of the property against all risks including Terrorism insurance. Dependent upon how the Terrorism is placed will determine the scope of the coverage. Loss of rent (usually for 3 years) is required so that if damage renders the property unlettable or triggers rent suspension clauses in leases, a recovery against the insurance can be made.

The loan documents will also require the lender to be an insured party in its own right (i.e. a composite insured, providing parallel cover unaffected by any act or omission of any insured parties) as anything less, for example interest noted, joint-insured or a general interest endorsement, will not be sufficient to protect the lender.

The lender will also generally request a loss payee clause to be included in the policy that provides for claims proceeds (usually above a specified amount) be paid only to it, thus avoiding the risk that a borrower might misappropriate these. Whilst this should ensure that there is no debate in who should receive the insurance proceeds the wording of any such clause should be checked to ensure that the wording does indeed allow for this.

Each requirement of the insurance clause is likely to require the policy to be endorsed or amended to exactly meet each obligation such as non-invalidation/non-vitiation, subrogation waiver and notice of cancellation.

There is also normally a requirement for the borrower and/or the insurers to notify the lender of any changes and non-payment of premium (allowing the lender to do anything that may be necessary to keep the required cover in place).

The lender must be satisfied that the insurers are of sufficient financial status to meet their financial commitments and ultimately pay claims and many agreements contain minimum ratings which insurers must meet or exceed for them to be deemed acceptable.

One of the key aspects of the insurance clause is to ensure that there is a waiver of the duty of disclosure for the lender or their agent. As a co-insured or composite insured party the terms and conditions of the policy must be adhered to. One of these conditions is that insured parties must make a Fair Presentation of risk. This includes all facts, information, and circumstances that are material to the risk that your business holds. This may be anything that would influence the judgement an insurer takes in fixing the premium, terms and determining whether to accept the risk. Failure to disclose such information can have far reaching affects including amendment of pricing and terms or policy avoidance. Lenders collect significant amounts of information at both the origination stage and throughout the lifespan of the loan. Determining which information should be disclosed to underwriters can be difficult to for those outside of the insurance industry and 'data dumping' is also prohibited; i.e. providing a mass of unstructured data which the insurer is to read through. Instead, pertinent information must be presented to the insurer where it is material to the insurance risk. As a result, lenders must obtain a waiver of their duty of disclosure to ensure that the insurance contract is maintained even if the main policyholder's rights fall away.

E.2 Legal Defects / Environmental Risk Insurance

An insurance policy can also replace or supplement due diligence reports in particular circumstances and cover, for example, defects with security assets or other inherent transaction risks.

These are usually taken out where time is short, information is incomplete, representations and warranties are not forthcoming or unreliable or the buyer's budget is limited. The principal risks covered by such insurance are:

- the legal ownership and intended use of the asset;
- planning and compliance with building permits;
- potential contamination of land or failure to properly remediate previously contaminated land;
- matters normally covered by a seller's representations and warranties, but which the seller cannot (usually because of insolvency) give;
- adverse or nil responses to pre-contract enquiries (e.g. where responses to a search of local authority records cannot be obtained in time);
- policies which support a sample-based due diligence review, where the portfolio is too large for each property to be investigated individually.

These types of insurance cover actual loss arising from a specified occurrence, are specific to that asset and transaction and last for a set period of time, usually without the need for any renewal or further premium. These policies typically cover depreciation in land value, penalties and third party settlement, loan interest, construction, alteration, demolition and legal costs and either insure the total property value, the loan amount or the estimated maximum loss (commonly, the insured risk will not be capable of causing a total loss of value, so it is always worth obtaining alternative quotes).

Such policies, in the UK, are often called legal indemnity, defective title or legal contingency insurances. It is not customary in the UK always to take out title insurance (this is normally only done to cover a specifically identified defect) and there are three main types of such policies, which provide different levels of protection:

- **Comprehensive:** insures the borrower's ownership of, and ability to use, the property for the intended purpose, the loan security (cover against fraud and forgery, unenforceability and priority problems) and costs and expenses incurred protecting the mortgage;
- **Limited Coverage:** insures a specific pre-existing flaw in legal ownership security (e.g. rights of light, lack/breach of planning or building permissions, restrictive covenants, easement issues, adverse possession, and chancel repair) including costs and expenses incurred in protecting the security; and
- **Search Replacement:** used where (when the loan was first advanced) the usual searches and enquiries of the local or other relevant authorities cannot be made, or where the replies to these are oral only for which the relevant authority will not accept responsibility.

It should be checked whether there are any outstanding claims on any existing policy, not only as the benefit of such may need to be assigned but also to ensure that the loan process does not prejudice this. However, where there are uninsured technical ownership and security problems, it may be better for the buyer, not the seller, to put this in place. The policy, or a commitment from an insurer for a policy, should:

- be taken out before contracts are signed, or there should be a condition precedent that this is done before closing;
- name the lender and/or borrower as insured (Limited Coverage policies usually also insure successors in title, mortgagees and tenants); and
- insure the lender for as long as the loan is outstanding (including where the lender is a mortgagee in possession or enforcing its security) and, if a borrower is the insured, should continue for the duration of its ownership or (if longer) for as long as it has any liability for any title warranties given on sale - Search Replacement and Limited Coverage policies can last indefinitely.

Many policies include inflation proofing cover – sometimes linked to an index but more often this will increase, up to a pre-set limit, at a pre-determined rate for each of the specified policy years. These policies, especially Limited Coverage, may also require the existence and content of the policy to be kept confidential and, in such a case, it is very important to comply with this (a seller’s undertaking might be appropriate) because any breach could prejudice the ability to claim and/or even allow the insurer to avoid the policy altogether.

SUPPLEMENTARY ISSUES

F. SUPPLEMENTARY ISSUES

F.1 Instruction Letters

The instruction letter will form the basis of the relationship between the report provider and the recipient beneficiary, and should therefore be as accurate and complete as reasonably possible.

Many report providers have standard terms of business which should be given to all beneficiaries of the report/survey as early as possible (otherwise the provider may not be able to rely on these). For example, the Red Book sets out basic terms of engagement for valuers.

The scope of engagement may be set out in a formal engagement letter written by the consultant/professional, or in an instruction letter prepared by the buyer or lender. Ideally, this should be countersigned by the receiving party to confirm acceptance and is often subject to negotiation. Generally, however, such a letter should expressly set out and list:

- the identity of the party or parties (including, for corporate entities, contact names) for whose benefit the report is being prepared and any other persons to whom the report should be addressed and who are to be able to rely on its contents;
- an outline of the relative transaction (this can often be achieved by attaching a term sheet) and the functions (i.e. buyer, lender, tenant, etc.) of the addressees;
- a description of the relevant property sufficient to enable it to be readily identified (a plan and/or photograph is useful for this);
- confirmation of the type/purpose of report (e.g. credit assessment, valuation, survey, legal) and the form and extent of reporting (i.e. high level, red flag or other) required;
- any exclusions and (if relevant) which documents will be reviewed;
- any particular assumptions to be made or disregarded and/or special requirements peculiar to the property, transaction or report beneficiary;
- details of when the report is required and any supplementary work envisaged;
- any due-diligence co-ordinator, parties and others with whom the report provider should liaise, the division of responsibility between advisers, whether advisers will be relying on other advisers' reports (and, if so, which) and/or to whom copies of the draft and final form report should be sent;
- the person or entity who should be contacted to obtain access or additional information required relating to the property;
- confirmation of any limitation or cap on the liability of or claims against the report provider, plus details of professional indemnity insurance requirements; and
- confirmation of fee basis and disbursements and/or other expenses agreed to be paid.

An incomplete or missing instruction letter may delay closing of the transaction or lead to additional expense in making additional surveys or enquiries. It can also cause disputes over fees and inhibit a buyer's or lender's ability to claim compensation for material inaccuracy or omission, or oblige the beneficiaries to accept a report the form and content of which is inappropriate.

Occasionally, unforeseen issues arise after an engagement has commenced which necessitate a change (for example tenanted premises may become vacant, or a buyer may wish to change development plans). These may necessitate consequential amendments to a due diligence provider's engagement and in such a case it is important that these are also clearly documented and agreed.

F.2 Reliance

Most due diligence reports contain restrictions on disclosure to, and reliance by, third parties. Any lender financing the purchase of real estate will, however, want to ensure it can rely on those reports because it or its advisers will have reviewed these and the decision to lend made on the assumption that the information contained in those reports is accurate. The lender will want to be able to claim compensation from the report provider for damages if the report is incorrect and, as a result, it suffers loss.

CREFC Europe has developed an annotated form of reliance letter (for more information, see this page: https://www.crefceurope.org/committee/6) that is intended to offer a reasonable compromise likely to be acceptable for the purposes of many due diligence reports relating to many transactions. The letter was developed with valuable input from the RICS and a range of market participants. An appendix to the letter sets out and discusses various alternative approaches and additional considerations that may be appropriate in particular circumstances.

A party commissioning any due diligence report should normally, before work is started, inform the report providers that their reports should be capable of being relied upon by any lender which finances the purchase and/or development of the property. The lender should either be an addressee of the report or the report provider should provide a separate reliance letter setting out the terms on which the lender will be given reliance.

A lender will typically expect to be able freely to disclose each report to:

- all relevant "finance parties", including not only the initial lenders and facility and/or security agent but also future syndicate members (who will expect to see and rely on this) – this is important for the lender to be able to sell its interest in the loan although, conversely, the report provider will want to manage its potential risk and not incur liability to a wide group of unidentified parties for an indefinite period;
- its advisers and, for a potential securitisation, rating agencies and other parties such as loan servicers (in addition banks and institutional lenders especially may need to be able to disclose the report to an affiliate and, in some case, disclosure to a third party may be required by law).

As a result, in practice, disclosure/reliance is often limited in time (e.g. to entities becoming lenders within a year of the date of the report) and to specific groups of future parties (for example any participating lender in a primary syndication or securitisation). Conditions on disclosure/reliance may also be imposed, for example that notice of any future beneficiary is given to the report provider, that the provider shall have no greater liability to any new party than it had to the original parties, that any third party disclosure be on a confidential basis and/or that any liability of the report provider is subject to a cap. A lender should be comfortable that any such limit or condition is appropriate in the context of the value and nature of the transaction and a provider should be satisfied that the extent of reliance is in accordance with the terms of its professional indemnity insurance cover.

It can be seen that the parties to which reports are addressed, to whom they may be disclosed and which may rely on them, and the terms of such disclosure and reliance, can vary within certain bounds, and may be negotiated if the use of an existing standard form is not agreed at the outset. It is advisable in such cases to discuss and agree addressees, disclosure and reliance terms early on during a transaction.

BEST PRACTICE PROTOCOL

G. BEST PRACTICE PROTOCOL

Each transaction and property will differ and dictate variable requirements and approaches. However, to avoid last minute problems, to maximise the benefits of the process and increase the understanding of all concerned, for the purposes of a loan secured (and any related asset purchase) on UK real estate, adoption of the following principles should assist:

- Professional teams should be identified and instructed at an early stage.
- The scope of each consultant's appointment, especially as to addressees, beneficiaries, further disclosure and special requirements, work to be undertaken and time limits should be clearly specified.
- Report qualifications and disclosure restrictions should be agreed with all beneficiaries and/or clearly specified by report providers before commencing work.
- A working group list should be circulated to ensure that all parties and their advisers remain fully appraised of the progress of the transaction.
- An initial meeting or conference call should be organised for all relevant advisors to discuss the parameters of the diligence process, identify the main risks and issues likely to be encountered and the process/ methodology to be adopted and determine individual responsibilities and a timetable.
- For larger (multi property) transactions, regular (at least weekly) update conference calls for all principal report providers should be arranged.
- Lenders should specify which copy reports should be sent to which other parties or advisors and appoint a due diligence coordinator with responsibility for monitoring progress and recording specific requests and feedback.
- Liability caps should be realistic (having regard to the provider's role and insurance cover, and the transaction value) and not quoted as a multiple of fees or a percentage of value.
- Report providers should promptly volunteer details (e.g. summary policy schedule or broker's letter) of professional indemnity insurance cover.
- Reports should be self-contained (i.e. not refer to other documents or conditions) and clearly set out their scope and the methodology employed. Plain English should be used and technical terms explained or defined.
- Data rooms should be organised in categories, all documents labelled and subsequent additions clearly identified and notified to all authorised users. The compiler of each data room should ensure that contents are up to date, filed, indexed correctly and checked before opening it to users, and electronic rooms should have sufficient capacity to be capable of use by several parties simultaneously and checked for ease of access/downloading before being opened.

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