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Limited Recourse Financing Series: The Need for Limited Recourse Structures

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Limited recourse financing (also sometimes referred to as "non-recourse") is a very common structure adopted in real estate financing transactions in Europe. The principle around limited recourse financing is essentially ring-fencing the assets which are placed in security in favour of the Lender, segregated from assets that are outside of the transaction. The Lender will only have recourse to the assets subject to security, without any recourse (or limited recourse) to any asset outside of the secured assets, nor against any entity outside the Borrower/Obligor group. The Borrowing entity is usually set up as a special purpose vehicle ("SPV"), and all of the Borrower's assets (which include the underlying real property(ies), along with associated assets affecting the cash flow, such as leases, insurance contracts, etc.) are subject to security for the facility.

In this series of articles in *REF News and Views*, we will look at some of the key features in limited recourse financing structures, as well as some common issues that may arise, in the context of real estate financing in the European market.

What is limited recourse finance and why is it used in real estate financing transactions?

The key principle of limited recourse finance is to ensure that the security and claim with respect to the loan is limited to only a prescribed set of assets and against prescribed entities. It is often used in the context of real estate finance because the fundamental source of recovery for the lender is the underlying asset (*i.e.*, the real property) itself and the cash flow it generates. In contrast, corporate finance facilities look to the creditworthiness of the Borrower and the trading group and therefore would generally require full recourse to all of the group's assets.

Benefits of limited recourse structures

Limited recourse finance is preferred for Sponsors who often have multiple projects. Limited recourse structures would allow the Sponsor to ensure each project is completely segregated. Importantly, if the loan becomes a non-performing loan and the Sponsor is of the view that the value of the asset has deteriorated to a point where it is no longer worth the investment, it is possible that the Sponsor could walk away without any further liability as the Lender takes over the asset.

From a Lender's perspective, limited recourse financing also provides certain benefits – namely, the pricing and the terms would be more tailored to the quality of the underlying asset and security in question, and the focus is on the lending to the one particular asset (or portfolio of assets). Lenders can also take comfort in the fact that its security and the vehicle it is funding would not be tainted by any other activities or portfolio holdings and liabilities outside the Obligor group. For this same reason, limited recourse financing is often used in leveraged facilities and project finance facilities.

Instances where limited recourse may not be appropriate

Given the premise of limited recourse financing relies on the fact that the Lender only has recourse to the ring-fenced assets, it goes without saying that in assessing the security pool, the value of the assets (and the cash flow associated with such assets) must be sufficient on its own to make whole the loan in the event of enforcement.

In addition, the quality of the asset and the cash flows are of particular significance, given this is the only route to enforcement. Assets that are not considered stable or do not have stable cash flows may not be suitable for this type of structure (as the Lender may require additional support). The most obvious example in this category would be construction facilities, where there are additional risks in the building process involved and the asset has yet to generate stable income streams. It is often required by the Lenders that, as part of the security package, a certain commitment from the Sponsor (whether this is a full recourse guarantee, or a commitment of a certain amount to cover

costs and overruns) would be required until the asset is “stabilised” and generating a certain amount or predictable cash flow.

Sponsor guarantees or commitments for a certain set amount may also be required in hotel financing, where the cash flow is quite cyclical, and due to the nature of the property being a hotel, its value is highly dependent on the health of the hotel business. It is often the case that, even in a financing structure where the property and the business are sitting under separate entities, and the financing is only provided to the SPV which owns the property and relies on the cash flow from a pre-agreed intragroup lease on a set rent amount, the Lenders would nevertheless look at the operating company which operates the hotel and, in some cases, the Sponsor for additional collateral. For more discussions on structures of hotel financing, please refer to our hotel financing **series**.

In instances where the Lender requires additional guarantee or Sponsor commitment, the financing is often structured so that the terms of such guarantee (or sometimes, if guarantees cannot be provided, is structured as investment commitments) are limited to a specified amount and the recourse to the Sponsor is therefore limited to this agreed amount. In addition, sometimes the ability to claim could be limited for certain triggers only (*e.g.*, cost overruns in a construction facility) and not as a general guarantee or indemnity.

In Part Two of this series next month, we will look at common features of limited recourse structures.