Westlaw Today
powered by Reuters

Collateral pool credit facilities: an option for growing industrial portfolios

By Chaz Weber, Esq., Colette DeRiso, Esq., and Sofia Skok, Esq., at Tucker Ellis LLP

JUNE 7, 2023

A. Introduction

While many commercial real estate market segments have been plagued by uncertainty (see retail and hospitality) or changing demand (see office), the enthusiasm for industrial and light industrial real estate assets has only been increasing, with surging valuations to match. Net market absorption for industrial assets hit 425 million square feet for the 12 months ending September 30, 2022, and the sector has the lowest vacancy rate at approximately 4%.[1]

This increasing demand, driven by e-commerce and the accompanying need for logistics and distribution hubs, has caught the attention of many REITs and other real estate funds traditionally focused on other market segments.

As these funds grow their portfolios, customary commercial mortgage real estate lending becomes more and more cumbersome and alternative financing structures become more attractive.

One option for owners growing their industrial portfolios is to consider a collateral pool (or unencumbered pool) credit facility.[2] These facilities feature facets of both corporate (specifically, asset based lending) and real estate finance, making their structure flexible but somewhat complex to inexperienced market participants.

Depending on the nature of the borrower/sponsor, these pool facilities may be mortgage secured, equity pledge secured, or unsecured, and may include full or limited recourse to a sponsor entity or principal.

Deal structure is ultimately dictated by the "creditworthiness" of the sponsor — a lender's calculation of their experience, assets included in the pool, balance sheet, and fund size — along with the sponsor's appetite for more restrictive pool requirements and tighter financial covenants.

Typically larger and more sophisticated REITs and funds will have access to unsecured facilities supported by a pool of unencumbered assets; whereas newer players, smaller funds, or funds targeted at riskier asset classes may only have access to pool securities secured by mortgages on the underlying real estate assets, or pledges of the sponsor's equity interests in those assets (similar to a mezzanine loan — and sometimes referred to as a "lightly secured pool").

This article will explore certain peculiarities of pool facility deal structure, contrast secured and unsecured facilities, and discuss the diligence and documentation necessary to be performed by a lender or sponsor's counsel at and after closing.

B. General deal structure considerations

a. Eligible properties

The fundamental feature of a collateral pool credit facility is that it is supported by a pool of "Eligible Properties" rather than a single commercial property as in traditional mortgage lending. In order to qualify as an "Eligible Property" and be included in the underlying pool of assets, the Credit Agreement will set forth certain criteria that are tailored to the asset class and expertise of the Sponsor.

Collateral pool facilities feature facets of both corporate and real estate finance, making their structure flexible but somewhat complex to inexperienced market participants.

For example, the Credit Agreement for a pool facility in favor of a fund focused on industrial real estate may require that each property is:

- Wholly-owned by a borrower or subsidiary guarantor;
- Operated as an industrial or warehouse facility located in the United States;
- Open and operating with tenants and leases approved by the lender;
- Free of any material title, environmental, or structural defects; and
- Not otherwise subject to any lien or encumbrance (other than permitted liens).[3]

Some pool facilities will also have baskets for alternative asset types — for example, a pool facility for an industrial portfolio may

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

allow 10% of assets (measured by value) to be vacant land for future development.

As industrial assets can often feature large, single tenant leases, understanding and underwriting the tenant and lease for each asset can be a critical component of whether a property qualifies for inclusion in the pool.

Once the pool of Eligible Properties is determined, credit facility availability is dictated by an advance percentage tied to the value of the pool. The advance percentage typically ranges from 50-70% and is dictated by the lender's evaluation of the underlying assets, perceived market risk, and whether the facility is secured or unsecured.

If the Credit Agreement dictates an advance rate of 60%, and the sponsor has contributed $100 million of Eligible Properties to the pool, then (absent other factors), the credit availability to the borrower would be $60 million.

Even among the pool of Eligible Properties, there will be certain additional limiting covenants governing the size, scope and nature of the property pool during the term of the Credit Facility.

Pool facility Credit Agreements commonly include limitations based on:

- A minimum (and/or maximum) number of properties in the pool at any time;
- The average remaining lease term for leased properties;
- The value of individual assets and the total pool value at any time;
- Concentration of assets leased to any single tenant; and
- Concentration of assets in certain geographical markets.

b. Borrowers and guarantors

One topic that should be addressed early in term sheet negotiations for a pool facility is credit party identification and structure. Typically each property in the pool must be owned by a separate single purpose entity, and the determination of whether those entities are "borrowers" or "guarantors" will have significant repercussions for loan documentation.

In our experience, especially where the sponsor expects to have an "active" pool — with a steady stream of real estate assets being contributed to or removed from the pool after the initial closing — it is best to make the property owning entities guarantors, rather than borrowers, as this greatly lightens the documentation load required for each property addition or removal.

C. Secured collateral pool credit facilities

Emerging funds and REITs will likely initially only have access to pool facilities that are secured by mortgages or pledges of equity granted to the lender[4] with respect to each underlying pool asset. When a credit facility is secured by the underlying real estate assets, the lender will require extensive due diligence regarding the real property being offered as collateral.

Mortgage-secured deals will require an appraisal of each pool property by an independent third party, full title insurance, survey, and all the routine requirements imposed by mortgage lenders such as a property condition report and environmental report.

In addition to the due diligence a lender requires, the credit parties must also comply with regulatory requirements unique to mortgage-secured lenders, including Patriot Act compliance, ADA compliance, flood certification, and other state-specific regulations.

These additional requirements unique to secured facilities tend to make them much more cumbersome — and document intensive — than unsecured facilities.

One unique consideration for mortgage secured pool facilities is how to structure and size title insurance.[5] In traditional mortgage lending, title insurance would be sized to the amount of the loan, but that doesn't make financial sense in a pool facility where the overall loan amount will be multiple times greater than the value (or advance rate) of any particular property.

Though it can be a negotiated point between borrowers and lenders, most pool facilities will size title insurance based on the advance rate as applied to the value of the specific asset being insured, as this provides adequate coverage for the lender while limiting excess cost to be paid by the borrower.[6]

Mortgage-secured and pledge-secured credit facilities are substantially less risky for lenders and may allow for a higher advance rate on pool assets than an unsecured facility.

However, the extensive due diligence also makes this form of credit facility much more cumbersome for both the sponsor and lender, and can diminish some of the efficiencies hoped to be gained by executing a pool facility rather than traditional single asset mortgage loans.

Over the long term, a secured facility may allow an inexperienced sponsor — perhaps one new to the industrial market — to grow and develop trust with a lender, potentially leading to future unsecured financings.

D. Unsecured collateral pool credit facilities

Larger, more experienced sponsors may be able to execute on unsecured pool facilities. Unlike the previously discussed secured transactions, unsecured credit facilities are supported solely by a pool of the REIT or fund's unencumbered assets[7] rather than mortgage or pledge-secured assets.

The availability of an unsecured credit is generally limited to more sophisticated and investment grade REITs with high creditworthiness, which is determined through a calculation of the REIT's experience, assets included in the pool, balance sheet, and fund size, and the loan availability is based on the value of the unencumbered assets.

An unsecured pool facility is attractive to both lenders and REITs for several understandable reasons. First, the structure allows the sponsor to obtain financing based on the value of its real estate assets without the restraint of actually encumbering those assets — thus making future acquisitions, dispositions, or refinancings much more efficient.

©2023 Thomson Reuters

Second, executing a large, unsecured financing signals the strength and creditworthiness of a sponsor to the market and potential investors.

Third, the lack of collateral protection (and the documentation required by it) eliminates all the cost and time associated with property-level diligence as discussed in regards to secured facilities.

While unsecured credit facilities can be highly beneficial to both parties, they do not come without certain risks and drawbacks. First, from the borrower's perspective, the sponsor may realize a lower advance rate and effective LTV in an unsecured credit facility than under a mortgage or pledge-secured facility, as lenders will hedge the perceived additional risk from a lack of collateral security.

From the lender's perspective, the lack of collateral presents additional repayment risk on a default, though this can be mitigated by the underlying creditworthiness of the sponsor and potential guarantor recourse.

The first line of protection available to lenders is the underwriting process. Lenders must be careful only enter into an unsecured credit facility when they are confident of the sponsor's creditworthiness.

Prior to executing a term sheet, the lending team should undertake an extensive underwriting process to verify the creditworthiness of the sponsor and its affiliated entities, and gain a level of trust and familiarity with the principals if it is a new customer.

Lenders must also work hand-in-hand with outside counsel to assure the loan documents reflect the terms of the loan and any recourse or other protections the lender expects.

This may include more restrictive covenants on both the pool of unencumbered assets and the borrower and guarantor entities, and additional financial covenants testing the ongoing economic health of the underlying assets and the sponsor (*e.g.* debt yield, DSCR, leverage ratios, etc.).

E. Conclusion

Whether secured or unsecured, collateral pool credit facilities can be an attractive option for sponsors looking to quickly grow their industrial portfolio. They limit the touchpoints required with the financing markets as assets are acquired and offer an assured financing option so long as the portfolio properties meet certain eligibility requirements for inclusion in the pool.

Experienced lenders and counsel can guide sponsors new to this type of financing through the underwriting, diligence, and documentation requirements unique to pool facilities.

Notes

[1] Nadia Evangelou, *Commercial Real Estate is Slowing Down in Q3 2022*, October 6, 2022, https://bit.ly/3qsQKuh.

[2] These credit facilities are also referred to as "unencumbered pool facilities" depending on structure (further discussed herein), but for ease of reference we refer simply to "pool facilities" for the remainder of this article.

[3] Note that the Eligible Property requirements are highly negotiated and customized for each transaction, and what constitutes a "material" defect or "permitted" lien will vary from deal to deal.

[4] For simplicity, we have referred to a single lender throughout this article. Large pool facilities are often syndicated to a group of lenders with the borrower interacting with the administrative agent for the syndicate.

[5] Similar considerations will be made in pledge-secured deals regarding whether to obtain UCC insurance and, if so, for what amount.

[6] Another title insurance consideration is whether to allow different title companies to insure different assets, or to require a single title insurance to insure all pool assets. Subject to considerations on co-insurance and reinsurance, the best option for a lender is to require a single title company across all assets as it allows for full implementation of the aggregation (or tie-in) endorsement across properties and offers practical logistical benefits as well.

[7] By "unencumbered assets", we mean that the individual properties are not otherwise pledged or mortgaged in favor of any third party.

About the authors

Chaz Weber (L), a partner with **Tucker Ellis LLP** in Cleveland, represents banks and other capital providers in complex real estate financing transactions. He regularly serves as lead agent counsel on complex syndicated credit facilities with a variety of collateral structures, including subscription-secured credit facilities, traditional mortgage-secured single-asset financings, and REIT or private equity real estate fund credit facilities secured by an underlying pool of mortgaged or unencumbered real property. He can be reached at chaz.weber@tuckerellis.com. **Colette DeRiso** (C) is an associate at the firm's Cleveland office, focusing on complex commercial financing transactions involving banks and other financial institutions — as well as public and private companies — in connection with secured and unsecured credit facilities. DeRiso represents financial institutions, private equity firms, and corporate borrowers. She can be reached at colette.deriso@tuckerellis.com. **Sofia Skok** (R), an associate at the firm's Chicago office, assists with real estate purchase and sale agreements, title and survey matters, leasing, and general real estate matters. Skok also works with banks and borrowers to facilitate financing deals, including assisting with credit agreements and construction loan agreements. She can be reached at sofia.skok@tuckerellis.com.

This article was first published on Westlaw Today on June 7, 2023.

© 2023 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.