



Credit Tenant Lease (CTL) Financing

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Introduction

Recent developments in the European economic landscape, such as inflation, higher interest rates and strict regulations for commercial banks, have prompted various types of borrowers to explore alternative methods of raising financing. This is especially true when it comes to borrowers seeking long-term funding, such as commercial real estate developers, shipping companies, large corporates and governmental organisations.

Credit Tenant Lease (**CTL**) financing is one such alternative method of financing. This article highlights its key features, challenges and benefits and is based on insights gained in our recent involvement in a large number of CTL financings across Europe and beyond.

Key features

Funders

Typically, a CTL financing is funded by institutional investors, including pension funds, insurance companies and asset managers. These entities provide funding through private placements, a financing method discussed in our recent article on this subject:

[Bespoke Private Placements: An Alternative Source of Debt Funding in Europe | Global law firm | Norton Rose Fulbright](#)

Borrowers

While currently not widely utilised in the Netherlands and the rest of Europe, CTL financing could be an appealing option for a wide variety of investors, sponsors and borrowers.

Structure

CTL financings are provided to the owner of an asset, such as a real estate property or a vessel. The relevant asset is leased to a tenant with a strong credit rating on the basis of a long-term lease agreement. Such lease agreement takes the form of a *double net*, *triple net* or *absolute net* lease, ensuring a stable stream of revenues for the asset owner for an extended period of time, typically ranging between 10 and 20 years. The financing itself can take the form of either a bond or a loan.

Rating agencies' assessment

In a more conventional real estate or asset finance context, the primary focus lies on evaluating the creditworthiness of the asset owner and assessing the collateral's value. However, when it comes to CTL financings, rating agencies shift their attention to the following factors:

- (i) the credit rating of the tenant;
- (ii) the lease terms and structure of the lease in relation to the asset;
- (iii) the probability of a default by the tenant under the lease agreement; and
- (iv) to what extent rental income will contribute to servicing the debt under the CTL financing.

Importantly, the asset's value holds less significance in the rating agencies' analysis for CTL transactions compared to conventional real estate or asset finance.

Given the comparatively low risk associated with net leases, lenders are generally willing to provide funding on favourable terms. These terms may include:

- (i) a lower interest rate;
- (ii) a longer term;
- (iii) a higher Loan to Value (**LTV**) ratio; and
- (iv) a lower Debt Service Coverage Ratio (**DSCR**) ratio.

Sectors

CTL financing can be used across multiple sectors, with the financed asset typically being a bespoke and a crucial asset for the operations of the tenant. Use cases include tank storage, distribution centres, warehouses, headquarters of large corporates, properties used in the public sector and data centres.

Net lease agreements

The net lease agreement

In terms of lease structures, the allocation of risk between the lessor and the tenant plays a crucial role for CTL lenders in determining the credit risk profile. Each of the relevant forms of net leases are briefly described below.

(a) Double net lease (or: NN-lease)

The double net lease is a commonly used lease structure for commercial real estate, whereby in addition to a fixed base rent, the tenant also pays the relevant taxes in respect of the asset and insurance costs. Maintenance and repair costs relating to the asset are usually borne by the asset owner.

(b) Triple net lease (or: NNN-lease)

The triple net lease is particularly advantageous for CTL lenders seeking a stable rental income with relatively minimal exposure to costs associated with asset operations. In addition to a fixed base rent, the tenant also pays the relevant asset taxes, insurance costs, and operational and maintenance costs. Depending on the cost allocation laid down in the lease agreement, major asset maintenance and repair costs may be borne by the asset owner.

(c) Absolute net lease (bondable lease)

The absolute net lease is the most attractive lease structure for lenders as the tenant is not permitted to terminate the lease agreement or to suspend any of its lease obligations. The tenant is obliged to continue to perform its obligations under the lease agreement at all times and under any circumstance. In addition to a fixed base rent, the tenant also pays asset taxes, asset insurance costs, operating and maintenance costs (including major maintenance costs) and any other costs relating to the asset.

Key elements and risks of net lease agreements

CTL lenders will favour an absolute net lease arrangement, where the (creditworthy) tenant bears all costs and expenses and assumes all risks associated with the leased asset. When evaluating a CTL financing, rating agencies examine the lease agreement carefully, with a specific focus on the following elements which are deemed critical:

(a) Term. The tenor of the lease agreement must at least be equal to the term of the CTL financing.

(b) Hell or high water. The tenant agrees to comply with its (payment) obligations under the lease agreement until the end of the lease tenor at all times and under any circumstance regardless of any rights the tenant might otherwise have to suspend its (payment or other) obligations (so called: "hell or high water" provisions). This means that any incentives, reductions, withholdings, break options or conditional payments under the lease agreement which may negatively affect the rental income are not allowed. This is important to ensure a predictable and steady rental income, which is used to pay debt service in respect of the CTL financing.

(c) Termination. In order to maintain an uninterrupted stream of rental income, the lease agreement may not provide for any termination rights or purchase options for the tenant, unless this would trigger full repayment of the outstanding amount due under the CTL financing (including make-whole costs).

(d) Allocation of liability. Any liability relating to the asset should be for the account of the tenant, including damage to the asset, environmental issues, licence/permit requirements, etc.

(e) Security. Security should be created over the total amount of lease receivables for the full tenor of the lease agreement. From a local legal perspective it should be considered whether the total amount of lease receivables can be recovered in case of bankruptcy of the borrower or the tenant as such amount will be required to fully repay the CTL financing. The outcome hereof may differ according to the jurisdiction. Any payment default risk under the lease agreement can be further mitigated by taking security over the asset itself and the relevant bank accounts, the use of a credit default swap, putting in place a parent company guarantee (or alternatively, a credit support letter or an equity commitment letter from the tenant's parent company).

(f) Fixed date-certain lease. The lease agreement should provide for a fixed date as of which the tenant is obliged to start paying rent. This may become relevant in case of a construction project if completion of the asset is delayed. The tenant should nevertheless start paying rent on the agreed fixed date. In such a case the contractor may become liable for delay damages, which may be used to compensate the tenant. Any payment default risk with regard to the contractor may be mitigated by a performance guarantee or parent company guarantee given by the contractor's parent company.

(g) Insurance. The asset insurance is usually in the asset owner's name, however the tenant must ensure timely payment of the insurance premiums.

(h) Parent company guarantee. Depending on the creditworthiness of the tenant, a parent company guarantee from the tenant's parent company may be required to ensure that the credit rating of the tenant is sufficient. CTL lenders may require having a direct contractual relationship with the parent company so that they are able to claim from the parent company direct in a default scenario.

Key challenges

Cooperation by the tenant

Persuading the tenant to collaborate with CTL financing could pose a significant challenge for the asset owner, given the stringent requirements set forth by CTL lenders in relation to the lease terms. The key incentive for the tenant lies in the prospect of reduced rent. This reduction is made possible because the asset owner can secure financing from CTL lenders at more favourable terms when opting for CTL financing. Particularly over an extended lease duration, this arrangement proves highly advantageous from a cost perspective for the tenant. Additionally, the tenant gains control over the asset and its development, as it is responsible for maintaining the asset. Moreover, the costs associated with the asset fall within the tenant's control, potentially remaining relatively low if efficiently managed by the tenant.

Local law restrictions

Careful consideration should be given to the relevant local laws involved, including the law governing the lease agreement, the jurisdiction of incorporation of the tenant and the jurisdiction where the relevant asset is located. CTL financings may not be an available option in tenant-friendly jurisdictions where local mandatory laws and regulations limit the possibility of CTL-proof lease agreements. For example, the "hell or high water provisions" as highlighted above, may not hold up in court if mandatory local law rules prevent the tenant from validly waiving its rights to suspend its payment obligations in case of a lessor default.

Also, it may not be possible in each jurisdiction to take security upfront over the aggregate amount of the lease receivables which are payable over the lifetime of the lease. In certain jurisdictions, such security would only capture the lease receivables due up to the time of enforcement of such security or up to the moment the security provider or tenant is declared bankrupt.

Change of law and regulations

A CTL financing (and consequently, the corresponding lease agreement) typically spans a more extended period, ranging from 10 to 20 years. Throughout this duration, parties may encounter issues arising from changes to the relevant local laws and regulations. Such risks are typically borne by the tenant.

Change of credit rating tenant

In CTL financing structures, any adverse change to the tenant's credit rating during the life of the CTL financing is typically not mitigated, and this risk is usually borne by the CTL lenders. Consequently, a thorough upfront assessment of the tenant's creditworthiness is essential.

Construction delays

Completion of capital expenditure (capex) projects may experience delays due to supply chain issues, geopolitical factors or contractor defaults (including insolvency). Consequently, it is prudent to assess whether a bank guarantee from the contractor is necessary, if a performance guarantee should be provided by the contractor's parent company, or if the asset owner can obtain a refund guarantee from the contractor to secure the repayment of advance payments in a contractor default scenario.

Accounting and tax implications

It will need to be determined, on basis of the applicable accounting rules, whether the leased asset should be recognised as an asset on the borrower's and/or the tenant's balance sheet. Such assessment may also have tax implications, which must be carefully considered from a local law standpoint as negative tax consequences could potentially affect the tenant's credit rating.

Why CTL financing?

Financing assets leased by tenants with a strong credit rating under a net lease agreement typically represents stable and low-risk returns for the borrower. From a lender's perspective, the risk of borrower default is reduced. Consequently, CTL lenders are willing to provide financing on more favourable terms. These terms may include reduced interest rates, a higher LTV ratio and a lower DSCR. In some cases, borrowers may not be required to contribute any equity, freeing up capital for other investments. Tenants can benefit from the CTL financing structure if borrowers factor in the lower financing costs into the rental price. This serves as a significant incentive for tenants to collaborate with borrowers, ensuring that the lease agreement terms are eligible for CTL financing.