PART 2 – CONFIDENTIAL FACTS AND ADVICE

DD2147
Title: Pocket 2017 funding allocation

Information may have to be disclosed in the event of a request under the Freedom of Information Act 2000. In the event of a request for confidential facts and advice, please consult the Information Governance team for advice.

The information below is not for publication until the stated date, because:

The information contained within this document is commercially sensitive, has in part been provided to the GLA in confidence as part of a funding application and if disclosed could prejudice the commercial interests of the GLA and/or Lloyds Bank and/or the Homes and Communities Agency and/or Pocket and their shareholders Related.

Following the completion of the contracting and due diligence process the GLA will publish the allocation, ensuring that commercial confidentiality is not breached.

Date at which Part 2 will cease to be confidential or when confidentiality should be reviewed: January 2018

Legal recommendation on the grounds of keeping the information confidential:

The information in this document is commercially sensitive and, if disclosed, could prejudice the commercial interests of the funding applicant (Pocket) and their other potential funders (Lloyds Bank and the Homes and Communities Agency (HCA)) who have supplied information in confidence to the GLA. The disclosure of such information could also impact adversely on the GLA's bargaining position with these parties and its ability to manage the allocations and detailed due diligence processes as well as the contract negotiation and finalisation process and thereby prejudice the commercial and business interests of the GLA.

For these reasons, it is considered that the information below is exempt from publication in reliance upon the exclusions contained in section 43(2) (commercial interests) of the Freedom of Information Act and because the public interest in withholding the information outweighs the public interest in releasing it.

Legal Adviser - I make the above recommendations that this information should be considered confidential at this time

Name Richard Stokes **Date** 27 July 2017

Once this form is fully authorised, this should be circulated with the Part 1 form.

Confidential decision and/or advice:

1. Introduction and background

1.1 The principles of the funding agreement with Pocket were set out in MD 2122. Since then, the terms of the facility agreement between the GLA and Pocket have been substantially agreed; as have the terms of a) the Intercreditor Agreement between the GLA, Lloyds and the HCA; and b) a Repayment and Performance Guarantee from Related.

1.2 In summary, the agreements work as follows:

- The funding will be treated as a recycling and recoverable grant facility with a longstop repayment date of March 2028 subject to bi-annual reviews commencing in March 2021.
- Pocket can use the facility to acquire land on a conditional (subject to planning permission) and unconditional basis and to fund agreed pre-development costs related to obtaining planning permission.
- Where the facility is used to purchase land upon which market sale (Pocket Edition homes) are to be built, it will be treated as a loan on full commercial terms to be repaid once planning permission is obtained and before development finance is in place.
- Pocket can retain a level of surplus from the sale of affordable homes that is commensurate with the level of risk the business is taking and is therefore compliant with State Aid regulations. The surplus is calculated as a percentage of profit on cost and will work in two stages. In stage one, it will be set at 9% profit on cost; and in stage two (expected to be from Q1 2020) this will fall to 6%.
- To assist Pocket with covering immediate expenditure requirements, the GLA has agreed to advance £4.9m of future surpluses on commercial terms to Pocket, to be repaid in 2020 once the company has achieved self-sufficiency as per its business plan.
- The GLA has a repayment and performance Guarantee from Related (as noted in MD2122, Related is a 50% shareholder of Pocket Living Ltd) to provide protection to the GLA in respect of use of funds for deposits, failure to develop and events of default triggered because of fraud, gross negligence, breach of negative fledge and certain insolvency scenarios.

1.3 The two senior facility agreements are awaiting signature pending approval of this DD. It is important to reiterate that the GLA will have a legal first charge on the sites that will only be subordinated to a senior lender once it has been repaid and development finance is in place at the start of the construction period for each scheme.

1.4 The sites to be acquired by Pocket using the new facility will be used for a mix of affordable housing, market housing and commercial use. The market housing on any type B (mixed tenure) site acquired will not exceed 30% of residential units. To ensure that the GLA is not providing public subsidy in respect of any non-affordable market housing element, interest of 8.4% will be charged on GLA funding. Once planning permission is received, the quantum of market housing in the scheme is determined. At the point of planning, Pocket will then repay the GLA Charged Account for the market element of the scheme, in addition to the interest accrued on funding for that portion of the site. This means that the GLA will have been repaid all funding and interest related to market homes before the GLA's charge on the land is subordinated to providers of development finance to fund the construction stages of the project.

1.5 Senior construction financing has now been secured from HCA and Lloyds Bank for the first seven sites. As per MD2122, the senior facility agreements have similar characteristics to a Revolving Credit

Facility (RCF), except that the headroom is limited to £20m, which acts as a 'bridge to sales receipts' (i.e. future construction finance is linked to the pace of sales receipts). The size of the facility will be the lowest of 55% loan-to-cost or 50% loan-to-gross development value. This provides an incentive for the right value sites to be acquired to optimise the efficiency of the programme and gives certainty of availability of development finance as new sites come into the programme.

Past performance and trajectory

1.6 The existing agreement, dated 19 July 2013, with Pocket Living (2013) LLP (see para 1.3 of part 1) enabled Pocket to acquire development sites on a subject to planning basis and deliver 665 affordable starts on site, of which 277 are complete and 388 are under construction. Within a buoyant development market, opportunities to acquire land on a conditional basis in London have been rare and have generally relied on public sector land sales, for which transactions typically take longer to complete.

1.7 In this context, the trajectory of delivery since 2013 is sound. Delivery has accelerated over the past two years as the Pocket platform has been built up to support delivery and become a recognisable component of the affordable housing offer for Londoners. With the new facility in place and the ability to compete in the market for unconditional purchases, Pocket can be expected to significantly increase its pipeline of development opportunities and therefore affordable housing delivery.

1.8 Nonetheless, Directors should be aware Pocket's delivery forecasts beyond 2019 has been reviewed by Capita as part of the due diligence and has found them to be over-ambitious and the modelling lacking in sophistication, not fully reflecting the realities of risks and events that make up the ebb and flow of delivery through development cycles.

Detailed financial due diligence

1.9 Capita, which provides treasury services to the GLA, was asked to undertake the financial due diligence of Pocket. Capita's review consisted of two main components:

i. a review of the numerical accuracy of Pocket's model and the financial health of the company

ii. an assessment of the viability of the company and commercial assumptions of the wider deal

1.10 Capita highlighted that the financial model was complex and there was a level of inaccuracy, which while not significantly material, gave cause for concern that forecast delivery beyond 2019 had not been considered in sufficient detail; and concern also that the forecasts had not taken fully into account the risks to delivery that characterise property development over a period of years.

1.11 Capita advised that the concerns with the model be further investigated to ensure that forecasting beyond 2019 is more realistic and that inaccuracies are removed through on going performance management and reporting. While there were no material differences in the Pocket model in comparison to the model prepared by Lloyds and the HCA for the first seven sites, there is the risk that some of the inconsistencies identified could lead to a material difference. A condition of the release of any of the new £25m will be that:

- Pocket develops a new, consolidated and detailed business plan model to support better monthly reporting and close monitoring by the GLA.
- Pocket addresses the inaccuracies and inconsistencies in its model identified by Capita.
- Pocket explains in more detail certain elements of its model, including how each assumption impacts on the expected outputs.
- For modelling beyond 2019, Pocket includes the level of detail and sophistication included in the Lloyds and HCA model as the basis for reporting to the GLA.

- The new model includes more nuanced and up to date information about current pipeline sites to demonstrate the 1,059 affordable housing starts are deliverable by the end of March 2021, that the revenue targets for Pocket Living are realistic, and that the GLA's facility can be repaid by the end of March 2028.

1.12 On the commercial assumptions of the overall deal, the Capita report notes that the programme is ambitious, represents a significant step change in delivery, and that there is a risk to the GLA's funding being repaid in full by 2028. Pocket reports, however, that it now has the team, contract structure and financial capacity to grow its land pipeline to ensure that it can meet delivery and repayment milestones. While officers will continue to exercise intensive performance and contract management of the GLA's investment, and this can be administered through enhanced reporting procedures, Directors should be mindful of the risks to delivery and repayment.

1.13 Note delivery prior to 2019 is less of a concern. There is an existing pipeline of sites, including those with planning permission, and for which there is development finance in place. For example, the Capita report notes that the 2017 forecast for starts relies on the timely delivery of 239 units at Varcoe Road, Bollo Lane and West Green Place. Bollo Lane received planning consent in March 2017, Varcoe Road achieved planning consent in July 2017, and West Green Place remains on track to start on site in October 2017. These projects are included within the senior finance facility for the first seven sites. Officers within Housing and Land therefore consider the 2017 starts forecast to be achievable.

1.14 The Capita report also highlights that the forecast of 454 affordable unit sales for 2019 appears to be very difficult to achieve, casting doubt on the sales forecasts for 2020 and 2021, totalling 632 units. However, it is important to note that the 2019 unit sales targets are dependent on the completion of sites that have largely already been identified and have senior construction finance secured. This significantly mitigates the delivery risk up to 2019, based on sites currently identified and underway, and therefore Housing and Land officers consider the 2019 sales forecast to be realistic. It is important to reiterate that Lloyds and HCA have sales shortfall guarantees, which further protects the GLA if sales do not proceed at pace for the first seven sites.

1.15 Finally, with regards to delivery targets from 2019 to 2021, the report details that achieving the construction forecast of 1,069 homes is reliant on the successful identification and securing of new A and B sites over a period of political and economic uncertainty, pointing to 'a potentially over ambitious business plan, which puts the target of continuing self-sufficiency beyond 2020 at risk.'

1.16 Since the due diligence report was commissioned, Pocket has informed the GLA that it has identified two further development opportunities that could bring forward 300 affordable Pocket homes. Pocket has exchanged contracts with the vendor on one of these opportunities. This would suggest that while the model does rely on a significant change of gear for Pocket, the new funding agreement and the ability to compete in the unconditional land market will enable them to do so. Nonetheless, to ensure that delivery targets and therefore the repayment of the GLA's funding can be met, Pocket will need to continue to secure development opportunities of this type and scale.

1.17 The site availability, market uncertainty and programme lag risks are outlined in Section 4 of this report. Officers are confident that an enhanced architecture of reporting that have been included in the loan agreement with Pocket will help to improve the impact of project performance and contract management and business review procedures. Additionally, the delivery and performance guarantee being provided to the GLA from Related ensures GLA funding is protected should a site be purchased but not achieve planning, or is otherwise undevelopable.

1.18 While the trading performance of the company has improved year-on-year over the past three and a quarter years, Capita's report raises concerns about the viability of the company based on a review of their audited accounts and whether the company can continue as a going concern long term. The company's finances will continue to be closely monitored and the new funding can bring the business to self-sufficiency, which Pocket projects will be achieved by March 2020. Capita's report also notes that Related is of sufficient financial strength to honour the terms of the guarantee.

1.19 It is important to note the risk of Pocket being unable to repay the £4.9m working capital loan is mitigated because repayment of the loan and the ability of the company to reach self-sufficiency is based on the successful completion of already identified sites, where the risk profile is known, rather than prospective sites.

1.20 Capita was unable to ascertain from the Pocket model whether, at the point of planning consent for each project with an open market sale component, Pocket will have the capacity to repay any of the commercial loan from the GLA for the market sale elements of the project. However, its report notes that 'having in place a strong agreement with ongoing close monitoring and strong management and monitoring of Pocket's performance and financial health will better enable the GLA to mitigate this risk as far as possible.' The GLA also has contractual security that it will not subordinate its first ranking legal charge on a site until it has been repaid.

Release of surpluses

1.21 MD2122 highlighted Pocket's inability to meet its current and projected overhead expenses under the existing contract, where the GLA pays Pocket a development management fee of circa £10,000 per development per month. It was proposed in the MD that Pocket be entitled to retain the surplus from Pocket Edition (market sale) homes and the investment level of surplus derived from affordable that would reflect the level of risk taken by Pocket and therefore be State Aid compliant. This would enable Pocket to meet the costs of its overheads and ensure that the revolving facility can grow over time such that more affordable homes can be provided.

1.22 Following Capita's review, the 10% level has been revisited and based on Capita's recommendations, it was determined that a two-stage profit release, based on Pocket's milestones for achieving self-sufficiency, is the most appropriate approach:

% of affordable profits on costs to be released to March 2020	9%
% of affordable profits on costs to be released after March 2020	6%

1.23 The above profit levels result in cash balances in all quarters across the business plan being positive, while providing additional security for the GLA's investment and ensuring that the fund continues to grow.

1.24 MD2122 also noted that as part of this new agreement, the GLA would allow Pocket to use an advance of the surpluses generated from existing Pocket (2013) schemes as a temporary interest-bearing working capital loan. Following the review of Pocket's business plan and the due diligence process, the amount has now been set at £4.9m with repayment by 31 March 2020 and interest charged at 11.93%. This loan is aimed at addressing the underlying overhead deficit that has built up to date and address the continuing under coverage of overheads.

1.25 In terms of security, as stated above, the GLA maintains a first fixed charge over the land: both until it has been repaid in relation to the facility used for any market sale Pocket Edition homes; and until a senior lender begins to provide construction finance, at which point the GLA's charge is subordinated. Because both Lloyds and HCA are providing construction finance, the GLA's charge becomes third-ranking behind both Lloyds and HCA once senior construction financing becomes active on a scheme. It is important to note that the HCA has agreed not to make decisions that could impact the GLA's security (i.e. call a default) before consulting the GLA and this will be captured in a side agreement.

1.26 An added protection to the GLA is that Related will be required to provide equity that flows in first before development finance is provided on any scheme, which will provide further security as it is proposed that this cannot be withdrawn from a development until the GLA has been repaid. Once a scheme completes, the senior lenders are paid back first followed by the GLA's funding, and lastly, Related's equity contribution is repaid.

1.27 The repayment and performance guarantee provided by Related is in agreed form and ensures that Related will step in if Pocket is:

- unable to complete a purchase where a non-returnable deposit has been put down
- unable to obtain planning permission or some other reason not be able to develop the site
- unable to obtain development finance within a prescribed period of time

1.28 The guarantee also covers the event that a senior lender calls a default when it has first charge on land purchased with the GLA's investment when the default is the result of fraud, gross negligence, breach of negative pledge and certain insolvency events.

1.29 Finally, a significant improvement to the GLA's security position under this new agreement compared with the current contract is the scheme by scheme approach to a development making a loss. If an individual development makes a loss such that the GLA's funding cannot be fully repaid with proceeds from the sale of affordable units, Pocket will need to make up the shortfall from private proceeds and equity before it would be entitled to access proceeds (private and affordable) from other developments that complete. This is an improvement on the current agreement which operates on a ratchet basis, whereby Pocket can make a loss on a particular scheme and instead of immediately reimbursing the GLA for the shortfall, these losses are offset by profits made from future developments.

2. Objectives and expected outcomes

2.1 From a policy standpoint, the Mayor's objective of delivering a large quantity of high quality affordable homes aligns with Pocket's business model and particularly its focus on providing innovative affordable homes for Londoners. The Housing and Land Directorate has asked all partners to be ambitious when setting their delivery targets to ensure that the Mayoral target of 90,000 starts by 2021 is met. While Housing and Land recognise that there is a high likelihood of Pocket's delivery milestones slipping at some point over the course of the term of the loan, in light of the above, the Executive Director of Housing and Land accepts the delivery risk outlined in Capita's report and in Section 5 of this report, and recommends that this funding is approved.

3. Risks

3.1 The GLA must be mindful of the inherent level of ambition and risk contained within the forecast Pocket programme from 2019 to 2021 and beyond.

3.2 The table below outlines the main risks detailed in the Capita report and the project team's mitigation approach to each risk (except those described in the finance comments):

Risk	Mitigation
Impact of sales and construction programme lag – impact of housing unit sales lag and potential construction programme lag based on knowledge of previous and current delivery performance	Lloyds and HCA have sales shortfall guarantees that will ensure that the impact of any sales lag is mitigated for the first seven sites. This will also be beneficial to the GLA in that it will ensure that sales lags do not prevent the GLA's funding from revolving. Request that Pocket introduces appropriate sensitivities to the Pocket GLA model for sales and construction lag risk, particularly in relation to larger sites and require improved and bi-annual business plan reviews.
Site availability – potential impact of difficulties with site availability in London. This could be due to market conditions or the result of political and legislative uncertainty (e.g. Brexit)	The new funding can be used to buys sites on both an unconditional and subject to planning basis, broadening the type of sites available for purchase. Significant mitigation measures have been included in the 2017 agreement to address the additional risks associated with the acquisition of unconditional sites, including the guarantee from Related which covers sites that are undevelopable for some reason, or which do not secure planning or development finance. The reporting requirements for the quarterly meetings will include an updated site availability review.
Housing market uncertainty – the potential volatility in the housing market over the period of the business plan and particularly for the period up to 2021	The GLA will undertake sensitivity testing of sales value assumptions within development appraisals at the time of site purchase and will monitor the housing market on an ongoing basis. Pocket is required to make an individual robust business case for each site and the GLA has absolute discretion over whether a site is purchased.
Ability of Pocket to repay principal plus interest at end of loan period – risk that Pocket is unable to repay the principal plus interest based on the full £51.4m loan position at any point up to the long stop date of 2028	The GLA's first ranking charge over land will not be subordinated or fettered in anyway until a senior lender begins to provide construction finance. The GLA will request following this approval that Pocket develops a new consolidated business plan model which incorporates a more sophisticated approach to future forecasting. The revised monthly reporting and monitoring procedures, and the formal delivery and performance reviews which will occur every two years, will improve the chances that repayment of the full principal plus interest is possible at the end of the loan period but GLA must remain mindful of the inherent risks identified by the Capita report and discussed in this Director Decision paper.

Financial strength of Related Companies LP and strength of its guarantee - The enforceability of the guarantee and the ability of the GLA to call of the guarantee currently and in the future, should there be changes to the financial strength of the company	The GLA has received a legal opinion from US counsel which opines that the guarantor has the capacity and has duly executed the guarantee in its jurisdiction of incorporation and will seek further advice to establish the validity of the guarantee if there is a need to pursue US assets or assets registered in other parts of the world. The GLA will stay abreast of any changes to the profitability and financial strength of Related, noting the advice within the Capita report that despite it clearly being a large and valuable group of companies that it is currently relatively highly geared relative to the partners' equity.

3.3 As part of agreeing to provide this additional funding to Pocket, the team has focused on implementing a project management and performance monitoring system that is as comprehensive as possible. The following additional measures have been included in the new loan agreement with Pocket:

- Consistent and comprehensive recording and reporting of project, programme and financial performance against agreed metrics including forecast and actual outputs, expenditure and income including reconciliation of expenditure.
- As part of any decision to support a site acquisition, a forecast profile of housing outturn and cashflow impact on the revolving facility in the context of the wider delivery of the programme and overall risk assessment.
- Quarterly programme reports with running assessment and risk rating of delivery of acquired sites against a programme forecast model.
- Updated businesses planning to inform bi-annual GLA decision to continue to retain or wind down the facility investment.

3.4 A revised list of conditions precedent (CP) has also been agreed, with the notable changes from the 2013 agreement being:

- Rather than a full planning consent, when the site is purchased on an unconditional to planning basis a report will be required from a town planning consultant outlining the proposals for the site and the likelihood of successfully obtaining planning consent.
- Because construction financing may not have been identified beyond the first seven sites at the time of acquisition, Pocket is required to provide details of the availability of senior funding and that the borrower will have sufficient senior funding and receipts to achieve practical completion of the affordable units on all previously acquired sites.
- Due to unconditional site purchases, red book valuations will not be possible in all circumstances so the valuation CP is now more broadly defined to be 'a valuation acceptable to the Lender'.

4. Financial comments

4.1 There are three key financial issues: the commercial loan assumed to be £3.75m for the market element of the developments; the commercial loan of £4.9m for working capital; and the repayment / recycling of the balance of the £51.4m grant. These issues are considered in turn in the context of the due diligence report from Capita.

4.2 The key conclusions from Capita's due diligence are that:

- There is potentially too much ambition in the projections for 2019 and beyond and no recognition of the more modest performance to date, the site availability, the construction and the economic risk.

- There is not enough recognition of the required risk sensitivities for each of the main elements of the forecast, such as sales profile, construction profile, cost profile, site mix profile and profit profile.
- There is too much complexity and a lack of transparency, which makes it difficult to review the business plan and for the GLA to be confident that the position is viable both now and in the future.
- There is too high a level of inconsistency and inaccuracy in the main Pocket GLA model, the emerging 2017 agreement documentation and the supporting management information.

4.3 The commercial loan assumed to be 15% of £25m (i.e. £3.75m) for the market element of the development is due to repaid in full at the point at which Lloyds and the HCA inject their capital. Up to this point the GLA has first charge over the land acquired and so has a normal level of security.Pocket has agreed that the GLA's first ranking legal charge over the land will not be subordinated or fettered in any way until the GLA's commercial funding and interest is repaid and a senior lender begins to provide construction finance.

4.4 Although the GLA has a fixed first ranking legal charge on the Charged Account (i.e. The funding and the profits from the sales) at all times and nothing can move in or out without the GLA's approval and although the progress made on existing sites is encouraging, the commercial loan of £4.9m for working capital is more problematic. In view of Capita's due diligence, the GLA should expect some slippage in Pocket's repayment of this commercial loan.

4.5 However, the most troubling element of Capita's due diligence concerns the overall assumption that Pocket will become self-sufficient by 2020 and the total GLA investment of £51.4m will be recycled / repaid by 2028. The Capita report comments that the GLA cannot realistically expect Pocket's business plan targets to be met. Accordingly, the policy justification of why it is worth risking failure / delay on grant being recycled is set out across this Part 2 and at para 2.1 in particular.

5. Legal comments

Surplus and State Aid

5.1 The GLA has sought specialist legal advice in relation to the State Aid implications of Pocket being able to retain a proportion of surpluses generated in the course of delivering affordable housing. Advice has been provided referring to European Commission rules in relation to Services of General Economic Interest (SGEI communication, para 61):

> *Reasonable profit should be taken to mean the rate of return on capital that would be required by a typical company considering whether or not to provide the service of general economic interest for the whole duration of the period of entrustment, taking into account the level of risk. The level of risk depends on the sector concerned, the type of service and the characteristics of the compensation mechanism. The rate should be determined where possible by reference to the rate of return on capital that is achieved on similar types of public service contracts under competitive conditions (for example, contracts awarded under a tender). In sectors where there is no undertaking comparable to the undertaking entrusted with the operation of the service of general economic interest, reference can be made to comparable undertakings situated in other Member States, or if necessary, in other sectors, provided that the particular characteristics of each sector are taken into account. In determining what constitutes a reasonable profit, the Member States may introduce incentive criteria relating, in particular, to the quality of service provided and gains in productive efficiency. Efficiency gains cannot be achieved at the expense of the quality of the service provided.*