PART 2 – CONFIDENTIAL FACTS AND ADVICE

MD2727
Title: Pocket Living Limited Funding Extension 2020

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.

This information is not suitable for publication until the stated date because:

The information contained within this report 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 Homes England 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 sensitive or when this information should be reviewed with a view to publication: 31 December 2021

Legal adviser recommendation on the grounds for not publishing information at this time:

Under section 43(3) of the Freedom of Information Act information is exempt if its disclosure would, or would be likely to, prejudice the commercial interests of any person (including the GLA). Under section 42 of that Act, information is exempt if its disclosure would, or would be likely to, involve the disclosure of advice that is legally privileged.

These are both qualified exemptions, meaning that information captured under section 42 and 43 can only be withheld if the public interest in withholding it outweighs the public interest in releasing it. The information below contains information relating to confidential assessments of the proposed additional finance and structure of the funding to Pocket. This is all commercially sensitive information, the disclosure of which would, or would be likely to, prejudice the commercial interests of the GLA. While there is a public interest in understanding the circumstances in which public money is provided to other bodies, it is considered that in these circumstances the public interest lies in maintaining the exemption.

If this information is considered for release pursuant to the provisions of the Environmental Information Regulations 2004, this information should be considered exempt information under regulation 12(5)(e) – where disclosure would adversely affect the confidentiality of commercial or industrial information where such confidentiality is provided by law to protect a legitimate economic interest.

The information below also contains legally privileged advice relating to the above, particularly in relation to State Aid. It is also considered that, in the circumstances, the public interest lies in maintaining the exemption and withholding the information.

Legal Adviser - I make the above recommendations that this information is not suitable for publication at this time.

Name: TfL Legal **Date:** 20 November 2020

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

Decision and/or advice:

1. Introduction and Background:

Facility

1.1 The existing £56.3m (Tranche A + Tranche B) funding is administered through the GLA treasury accounts. Reconciliations are agreed on a monthly and per transaction basis between GLA Housing and Land, Treasury and Finance to ensure all parties agree on the fund position and headroom. Monies associated with surplus, equity release and other matters pertaining to the cascade of funds operate in accordance with the requirements of the 2017 Intercreditor Agreement in which Lloyds act as a Common Security Agent.

1.2 Tranche A is a working capital loan and is currently fully drawn. Tranche B is a revolving facility. As a result, the balance frequently changes as Pocket undertakes development activity that requires expenditure, drawing down on the facility and then derives proceeds through sales, repaying the facility which subsequently recycles within the Tranche (B) to the facility limit of £51.4m. A summary of the current facilities is highlighted below:

Project	MHC- Pocket Living
Funding stream	Affordable Housing Programme 2016 – 2023 Budget
Counterparty	Pocket Living
Commitment Date	25/8/2017
Expected Maturity	Tranche A – 31/3/2023 Tranche B – 31/3/2028
Estimated IRR	Tranche A – 11.93%, Tranche B – 8.4% for market/commercial units
Total Committed	Tranche A - £4.9m working capital loan, Tranche B - £51.4m revolving loan facility – Total - £56.3m
Total Invested	Tranche A - £4.9m, Tranche B - £47.9m, (£3.5m remaining headroom in the Tranche B facility)
Amount Recycled	£32,986,829
Remarks	Amounts repaid to the GLA in respect of Tranche B are available to be redrawn provided that the tranche commitment (£51.4m) is not exceeded and is repaid by the repayment date

Headroom

1.3 As part of the 2017 Facility Agreement, surplus profits are held in a locked account and only accessed to pay operational costs as a way to 'top up' the GLA facility (locked-up profits or "LUPs"). The current proportion of surplus profits able to be accessed by Pocket is set at 9% of affordable housing receipts. This will drop to 6% in March 2023.

1.4 It was identified in Q4 2019 that a forecast deficit of £5m would occur in Q4 2020. This was due to be managed predominantly by the release of locked-up profits from sites under construction (as agreed by the lender group in line with the facility agreement).

1.5 The Q4 2020 deficit has been largely managed due to Pocket successfully completing on a scheme during the Covid-19 pandemic resulting in the GLA being repaid £3.6m in September 2020.

1.6 The current budget profile forecasts that Pocket will move into peak deficit on the Tranche B facility from February 2022 until September 2022. Commitment from the GLA on the £5m Tranche C short-term loan facility is required now to provide the certainty needed for Pocket to begin to secure sites as part of the additional delivery agreed to be brought forward (115 affordable starts) as a condition of the GLA providing additional funding.

Delivery

1.7 As part of the proposal for the additional Tranche C £5m short-term loan, Pocket have agreed to provide an additional 115 homes (to be written into contract) above the original 1,148 target to total 1,263 homes by 31 March 2023. The table below summarises current and forecast delivery performance against the 2013, 2017 and soon to be confirmed 2020 Amendment and Restatement Facility Agreements and supports that Pocket are on target to meet their contracted delivery.

1.8 1,148 is the first overriding purpose of affordable housing starts to be contractually delivered. This is set as a milestone delivery target by March 2021 (extended to March 2023).

1.9 2,457 is the second overriding purpose of affordable housing starts. This is not a milestone delivery target, but Pocket are contracted to provide this additional delivery by March 2027.

Starts on Site	2013 Contract	2017 Contract (1st overriding purpose)	2020 Amendment and Restatement contract	Total
Required starts (Contracted)	**665**	**1,148**	**115**	**1,928**
Delivered starts	665	210	0	**875**

Remaining contractual starts to be delivered by 31 March 2021 (extended to March 2023)	0	938	115	1,053

Projections

Yet to start on site but funding drawn down from GLA facility	932
Yet to start on site with funding not yet approved or drawn down the GLA facility	68
Total schemes identified but yet to start on site	**1,000**

Total

Total starts delivered and projected	**1,875**

Shortfall and Pipeline

Current shortfall of starts on site against required starts (contractual)	53

Units identified with a high probability of land acquisition in Q1 2021	140

Additional units identified for land acquisition in 2021	314

1.10 Per section 1.6 in Part 1, this MD seeks to confirm extending the original date of delivery of the 1,148 starts by 31 March 2021 to 31 March 2023. Given the current contractual milestones leading to this target have been missed resulting in a technical breach of the Facility Agreement, Reservation of Rights letters have been issued confirming the GLA's acknowledgement of the breach. Pocket's agreement to bring forth an additional 115 affordable starts by 31 March 2023 enhanced by evidence of 454 units identified for acquisition in 2021 (per the table above) provides GLA officers comfort and validity in recommending the additional funding request despite the current technical breach. Per section 1.22 & 1.23 in Part 1, as part of the updating legal documenting to take place, revised milestones leading to the final required total 1,263 starts in total by 31 March 2023 will be agreed.

Proposition terms

Coupon

1.11 As described in 1.24 of Part 1 of this MD, an interest rate (below the market rate) will be introduced in respect of the Tranche C £5m facility where the funding relates to affordable homes, to be repaid together with any outstanding principal within two years of the Tranche C facility being made available with a final repayment longstop date anticipated to be 31 January 2023. This is a divergence from the current Tranche B facility where GLA funding is provided at 0% interest on the funding relating to affordable housing delivery (see section 1.5 in Part 1 of this MD). Introduction of a coupon where the funding relates to affordable delivery will encourage the route to self-sustainability for Pocket.

1.12 For the proposed Tranche C facility, the interest rate consideration (in respect of the affordable housing delivery) has taken into account Pocket's financial strength and credit worthiness. Consideration also has to be taken as to what the business can bear for it to remain able to leverage senior lending, given that it is a low-margin enterprise. This has been assessed, and a proposal recommending a fixed rate of 3% has been reviewed and endorsed by the GLA Interest Rate Setting Board.

1.13 Where a site is acquired pre-planning with GLA funding and upon the grant of planning permission the scheme will deliver private housing or commercial units, the GLA will continue to require repayment, including a commercial interest payment into a GLA charged account (subject to the payment waterfall in the Intercreditor agreement) following the current contractual terms. This is to ensure that the GLA is not providing public subsidy in respect of any non-affordable housing elements. GLA officers have reviewed the commercial rate in line with the GLA loan matrix, credit worthiness and collateral and recommend a rate of 4.27% (based on the variable EC reference rate) be set. This proposal has been taken to the GLA Interest Rate Setting Board for review and endorsed by that board. This is a lower rate than the commercial interest rate charged on the Tranche B facility granted in 2017 as Pocket's creditworthiness has been assessed as having improved since this time. Since the Tranche B facility was provided in 2017, Pocket's Net Asset Value has increased by £14.4m (adjusted to account for Related investment).

Facilitating re-financing and earlier recycling

1.14 The GLA currently does not permit the release of dividends to Related until the end of the GLA facility in 2028, unless deemed acceptable within the business model.

1.15 Alongside the £5m Tranche C facility, the GLA will look to facilitate a model for the GLA to be refinanced early on schemes via additional investment from external investors – in the first instance this is anticipated to be Related. This will be in return for enabling Pocket to access locked-up profits to pay a dividend to such investors (on completion of scheme build and sales) earlier than would otherwise be possible. In short, investors would be able to draw dividends at an earlier point than the current structure allows.

1.16 The structure will provide incentive for Related and other investors to provide additional investment into Pocket by refinancing the GLA on certain schemes where appropriate. This will reduce GLA exposure whilst simultaneously enhancing the recycling element of the facility, by ensuring a faster recycling mechanism of funds back into the facility for re-deployment as a result of earlier repayment on individual schemes.

1.17 The refinancing mechanism as prefaced above will be structured into the documentation in line with legal recommendations. The mechanism will enable only commensurate returns to be made by investors where applicable by ensuring a proportion of returns (available as a dividend) will be maintained as 'locked up' within the GLA charged account after debt and equity have been repaid.

1.18 The level of returns to be received by the investors and maintained as 'locked up' profits will be assessed on a case by case basis and directed by the level of profits available from the scheme. GLA officers will aim for a minimum of 6% of profits remaining after debt and equity repayment to be kept within the GLA structure as 'locked up profits' where possible.

1.19 The current 'locked up profits' structure which is currently in place on the GLA Tranche B facility will be adapted during the documentation stage to accommodate external investment and will seek to protect business sustainability as well as mitigate the risk of excess profits being made by Related or other investors. This will be subject to negotiation and commercial advice will be sought if appropriate. Additionally, the GLA will take measures where possible to ensure dividends are preferably re-invested by Related back into the Pocket business model.

Other external investment

1.20 Pocket are also in discussions to seek additional project equity investment from external investors. This may be injected into schemes the GLA has not funded. The purpose of these discussions is to improve Pocket's weighted average cost of capital, the scale of its capital stack and to ease its administration. Any additional equity brought into the Pocket business model will provide additional delivery with less reliance on GLA funding. Broadly, this would be received positively. Contract negotiations will document how any affordable delivery via this method up to March 2023 can be included as GLA delivery. Further analysis will be undertaken as any such deal progresses on the impact on the GLA funding, delivery and any additional risks and mitigants that will need to be considered.

1.21 The principle has been agreed with Pocket (to be confirmed and documented in the contract negotiation phase) that in exchange for the GLA permitting a development management ("DM") fee from any external investor providing additional project equity into schemes which the GLA has not funded, a proportion of returns will be directed to locked-up profits maintained in the GLA charged account. GLA officers have broadly outlined a cap of 6% of affordable housing receipts which the DM fee and any associated 'Promote' fee to be made by Pocket must not exceed. This broad cap will be reviewed at the time any proposition is brought forward to be deemed if still appropriate.

1.22 It is understood any Promote fee would be paid to Pocket only when a scheme makes sufficient returns. The current structure outlined is on the basis of a 20% Promote fee, of which GLA officers have negotiated a % to be maintained as locked-up profits to ensure security and sustainability for the Pocket business. GLA officers will review any proposition brought forward on a case by case basis with relevant amendments made to the broad outlined figures as appropriate.

1.23 Once scheme returns reach a threshold of 6% of affordable housing receipts, GLA officers anticipate distribution broadly to follow below:

Investor	**Equity Investment**	**Return on equity investment**	
External investor	90%	**70%**	
Related	10%	**10%**	
OR	**OR**		
Pocket	10%	**10%**	
Split of Pocket 10% equity return		***Pocket***	***Locked-up profits***
		75%	*25%*
Pocket Promote return		**20%**	
Split of Pocket Promote return		***Pocket***	***Locked-up profits***
		25%	*75%*

1.24 This broad structure has two aims: (i) to continue to ensure the build-up of funds to protect the Pocket business and continue to enable guaranteed recycling of funds into delivering schemes and affordable housing; and (ii) to ensure returns are commensurate for the Pocket business where applicable.

Other considerations

1.25 Pocket are currently in refinance discussions with both Lloyds (Senior Lender) and Homes England (Mezzanine Funder). As a fall back, should the discussions with both funders not progress as anticipated, Pocket are exploring options for alternative senior lending and would also be open to considering alternative mezzanine lending.

1.26 Through the 2017 contracting process, the GLA entered into an Intercreditor Agreement with the lending group (Lloyds and Homes England) following MD2122 and DD2147, in which Lloyds acts as the common security agent. GLA officers propose seeking to retain the terms of this agreement with the existing lending group wherever possible but will make best practice improvements if required, subject to the consent of the other parties.

1.27 If the lending group is to change or there are to be additional investors into the business for the commercial benefit of Pocket, it will be a condition precedent of any revised GLA Facility Agreement that alternative lenders enter into an Intercreditor Agreement on substantially the same terms as the current intercreditor arrangements, unless it is deemed unreasonable to do so. Critically, all parties must agree to the security requirements that the GLA outlines in the current Intercreditor as the first ranking creditor prior to any development finance being drawn, and first ranking creditor at all times in relation to the GLA charged account.

External commercial advice

1.28 KPMG were appointed as commercial advisors as part of the ongoing due diligence into the continued GLA investment with Pocket Living Limited in July 2019. Their main brief was to review the full Pocket business plan, to interrogate the state of its accounts and ability to repay the GLA at the proposed dates. They were also asked to review the due diligence conducted by Capita for the 2017 deal to independently assess whether the business has improved its operations and stabilised. Some of the advice undertaken is viewed as still relevant for this MD, see Part 1 (1.16).

1.29 The draft key findings and recommendations from KPMG have been re-considered and the draft summary findings relevant for this MD are highlighted below for reference.

1.30 On the business plan review:

- For GLA, this is more a strategic risk than financial. Failure to achieve the proposed increase in delivery does not necessarily increase financial risk as the GLA loans are only drawn as sites are identified and available. However, failure to achieve the desired number of units delivered would undermine the strategic rationale for extending subsidised loans for a greater quantum.
- The financial assumptions that underpin the business plan have no material departures from market benchmarks and compare to historical schemes delivered.
- The review by Capita Asset Services in 2017 made a series of conclusions on the overall position of the business plan at that point. In summary:
    - the ability to deliver the level of development growth forecast remains a key risk to the business plan;
    - the business plan is supported by an independent development appraisal model for each scheme, which contains detailed project-specific information;
    - there has been significant work to improve the transparency of the business plan, although the consolidated financial model is still in development; and
    - any information provided by management for the purposes of this report has generally been consistent with the business plan. However, this does not constitute a formal review, which GLA should undertake prior to investment.

Company strength and capital stack

1.31 The above referenced changes as outlined in this MD (Part 1 and Part 2), namely the Tranche C GLA short-term loan facility, and a mechanism to enable locked-up profits to be released early in combination with any potential external equity investment, provides a clear path for Pocket to become a sustainable affordable delivery agent, whilst slowly releasing reliance on GLA funding for the remaining period of the GLA facility.

1.32 Related increased its shareholding to 70% in early 2019. Related has a call option for a further 10% in 2021. Given Pocket's improving financial performance, GLA officers believe this will be implemented. In 2025, there is both a put and call option which if exercised would take Related's interest in Pocket Living Ltd (a Pocket Living 2017 Limited holding company) to 100%. There is a risk that Pocket re-finances the total GLA facility earlier than anticipated with another party, so they would no longer be obliged to deliver the housing targets outlined in Part 1 of this MD. There are contractual mechanisms in place to protect the GLA's investment, affordable housing delivery and return at such early repayment. These controls will be reviewed and updated in line with legal advice if appropriate during the documentation of the outlined changes.

1.33 Pocket's current financial commitments:

Lender	Loan	Current interest rate	Non-utilisation fee	Type
GLA (tranche A)	£4.9m	11.93%	0%	Revenue finance
GLA (tranche B)	£51.4m	0% / 8.4%	N/A	Junior finance
HE	£33.7m	7.27%	7.27%	Mezzanine finance
Lloyds	£89m	3.96%	1.6%	Senior finance
Related	£26m	15%	15%	Unsecured Subordinated debt
Crowd Cube - PLL	£1.7m	10%	N/A	Crowdfunding
Crowd Cube - PLC	£1.1m	7.5%	N/A	Crowdfunding

1.34 Pocket's proposed financial commitments:

Lender	Loan	Current interest rate	Non-utilisation fee	Repayment Date	Type
GLA (tranche A)	£4.9m	11.93%	0%	2023	Revenue finance
GLA (tranche B)	£51.4m	0% / 8.4%	N/A	2028	Junior finance
GLA (tranche C)	£5m	3%/6.5%	N/A	2023	Junior finance
HE	£33.7m	7.27%	7.27%		Mezzanine finance
Lloyds	£89m	3.96%	1.6%		Senior finance
Related	£26m	15%	15%		Unsecured Subordinated debt

Market context and stress testing

1.35 The housing and wider economic market are currently undergoing a turbulent period as a result of the impact of the Covid-19 pandemic. Initial stress testing has been undertaken to assess the resilience of Pocket within a changing market. The modelling tested lower forecast margins on schemes by 2%, increased operational costs by 20% and slower build and sales timelines by three months each. A fall in sales values of greater than 21% has to occur before Pocket are unable to repay the GLA in full from revenues generated across its committed portfolio at that point in time.

1.36 It should be noted that the GLA approved in April 2020 access to £3.87m of funds which Pocket otherwise would not have been able to access: locked-up profits. This was in response to the impact of the Covid-19 pandemic and was within the framework of the facility. Additionally, Pocket were due to repay interest of £1.7m on the Tranche A facility in April 2020. The GLA agreed to defer the interest due for 1 year (until April 2021) on a capitalised basis.

1.37 Despite the current severe market stress, Pocket have repaid the GLA £4.2m to date this year from schemes which have successfully sold throughout the Covid-19 pandemic, testament to the level of demand for the Pocket product.

2. Legal comments

State aid

2.1 The 2017 Facility Agreement was structured so as to be State aid compliant in accordance with the Services in the General Economic Interest (SGEI) Decision (Commission decision 20 December 2011 – SGEI – notified under document reference C (2011) 9380). The SGEI Decision permits public funding for affordable housing up to a maximum compensation/subsidy calculated as the net cost incurred in delivering the affordable housing including a reasonable profit.

2.2 In basic terms the net cost is the difference between the cost of operating the SGEI (which would include the cost of financing, site preparation, construction, building works and other services in so far as such costs are attributable to the affordable housing) and the revenue received in relation to the SGEI (i.e. the receipts from the sale of the affordable homes). For schemes which are mixed tenure any shared costs must be properly apportioned in accordance with generally accepted accounting principles and recorded in separate management accounts. The difference between the total costs and revenue of the affordable housing is the maximum aid/subsidy which can be given under the SGEI Decision.

2.3 Provided that any difference between the market interest rate and the interest rate applied, together with any other public funding received for the relevant project, does not exceed that maximum aid then no State aid will arise.

2.4 The above analysis is applicable to the proposed new Tranche C.

2.5 As explained at paragraphs 1.12 to 1.17 above, it is proposed that in order facilitate faster recycling of funding under the 2017 Facility Agreement for additional schemes, Related (Pocket's shareholder) – or potentially another investor - will repay the GLA funding in relation to certain schemes which have not yet started on site. In return the GLA would release its security over those schemes although Pocket would still be obliged to deliver the affordable housing outputs on those sites and to pay the receipts into the GLA charged account after the development finance costs have been repaid. GLA will then permit Related (or such other investor) to take a certain amount of those proceeds from the charged account. The parties intend to amend and restate the 2017 Facility Agreement to facilitate this.

2.6 External legal advice has been sought as to whether early refinancing and allowing Related to withdraw profits from the charged account gives rise to any risk of State aid non-compliance. The advice received confirms that the same State aid analysis applies to both the existing Facility Agreement structure and the proposed refinancing. The only difference arising as a result of the proposed refinancing is in fact that the amount of subsidy will effectively be reduced by the refinancing as the GLA loan period will be shorter. The subsidy will be the amount of any market interest foregone from the date of the grant of the loan to start on site when the funding is repaid by Related (or other investor), rather than to the original later repayment date. In both instances the risk of incompatible State aid arising, for example if Pocket failed to deliver the affordable housing, is managed under clause 28.5 of the Facility Agreement through the ability to claw back funding in the event of any State aid non-compliance.

2.7 With regard to permitting Related to withdraw profits from the GLA charged account, external lawyers have confirmed that provided the SGEI maximum compensation cap has not been breached in relation to the scheme then there should be no State aid issue. In terms of a limit on withdrawals by Related, the SGEI Decision restricts the level of profit a provider can charge for the provision of affordable housing to "a reasonable profit". However, the amounts Related would be looking to withdraw would not technically be traditional profit but also relate to recovering their refinancing investment. Paragraphs 1.15 to 1.17 above explain that the amount which Related or another investor will be able to withdraw will be agreed by the GLA on a case by case basis to mitigate the risk that an investor makes more than a reasonable level of profit.

2.8 The general purpose of the GLA charged account is to ensure that there are sufficient funds to repay the funding to GLA and for reinvestment in affordable housing. From a commercial perspective, although the GLA's funding will have been repaid prior to the development phase on schemes where Related or another investor re-finances, the GLA may want to ensure there are sufficient amounts in the charged account to give comfort that the GLA would be able to recover from Pocket in the event of overcompensation, for example if the affordable housing was not delivered.