

PART 2 – CONFIDENTIAL FACTS AND ADVICE

DD2530

Title: Garratt Lane – Atheldene Road Regeneration Site Loan

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:

It contains commercially sensitive information relating to the assessment of the proposed structure and terms of the funding to Higgins Homes PLC, the disclosure of which might prejudice the commercial interests of the GLA and other organisations. It also contains legally privileged advice relating to that information. In these circumstances, it is considered that the public interest lies in maintaining the exemption and withholding the information

Date at which Part 2 will cease to be sensitive or when this information should be reviewed with a view to publication: **31 July 2022**

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

Under section 43 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 information that is legally privileged.

These are both qualified exemptions, meaning that information captured under sections 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 structure and terms of the funding. This is all commercially sensitive information, the disclosure of which would, or would be likely to, prejudice the commercial interests of GLAP, and other organisations specified below. 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 and withholding the information.

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 connection with the subsidy control system. 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: 10 February 2021

Decision and/or advice:

1. Counterparty

- 1.1 Higgins Homes PLC is the in-house developer subsidiary of Higgins Group PLC (the TopCo) and has been offered as the counterparty to the transaction – it will benefit from the transfer of ownership of the land to be developed from LB Wandsworth.
- 1.2 Another main active subsidiary of the TopCo is Higgins Partnerships PLC which delivers Joint Ventures and main contractor services to Registered Providers (RPs) or Local Authority Partners.
- 1.3 The remaining main active subsidiary is Higgins Investments PLC which holds the commercial assets of mixed-use developments for the Higgins Group, as well as a business park.

Creditworthiness:

Higgins Homes PLC

- 1.4 Higgins Homes PLC benefits from a Creditsafe rating of B (“low risk”) based on their 2019 audited accounts. The more recent July 2020 audited accounts have been reviewed and were recently submitted to Companies House. These show additional improvements with profits showing an improvement in the last year (£147k in 2020, -£820k in 2019, £2.8m in 2018).
- 1.5 The net tangible asset position for the subsidiary has also remained stable (£20.75m in 2020, £20.6m in 2019, £21.4m in 2018) and is primarily composed of profit reserves (circa £20m in 2020, £19.846m in 2019) which shows good access to liquidity.

Higgins Group PLC

- 1.6 Higgins Group PLC also benefits from a Creditsafe rating of B (“low risk”) based on their 2019 audited accounts. As above, the more recent July 2020 accounts have been reviewed albeit show a reduction in net assets in the last year (£44.842m in 2020, £52.390m in 2019, £56.196m in 2018) – more than 50% of the reduction was attributable to increases in pension liabilities: the company operated a final salary pension scheme which is now closed but requires revaluation ever year. This pension scheme is funded via equity investments in the stock market – the performance of the stock market in the last year has created a wider discrepancy between assets and liabilities for this specific line of accounts.
- 1.7 Other factors include COVID 19 which has impacted the turnover of the company, given its activities as a main contractor and developer. Additionally, the asset portfolio of Higgins Investments PLC was revalued during the pandemic which has seen valuations reduce for assets comprising retail and restaurant uses.
- 1.8 Notwithstanding the above, the Higgins Group PLC retains high levels of profit reserves (£42.7m, 2020).

2. Loan Terms

Commitment and applications:

- 2.1 The senior debt commitment is capped at £23.5m – this is however split into two separate tranches: one of £17.3m for phase 1, and one of £23.5m for phase 2. The tranche sizing has been conducted in line with the covenants defined below and following a red book valuation carried out by Avison

Young. At no point in time can the total facility drawn exceed £23.5m, should the facilities for phase 1 and phase 2 be drawn simultaneously.

- 2.2 The loan will finance the land costs and development costs of the project up to the caps allowable in the financial covenants. The overall loan term is 5 years, with a final repayment date of 30 December 2024 for phase 1 (the first tranche), and 23rd of March 2026 for phase 2 (the second tranche).
- 2.3 The funding of both land and development costs was crucial to enable this project: the regeneration aspect of the project entails a long programme for 193 units (5 years) which entails a long equity tie-up period for the developer. A traditional development finance facility where land is fully funded by equity would result in an undesirable equity multiple for any private developer undertaking this project and would effectively stall the project.
- 2.4 The drawdowns will be released to the borrower as project development costs are incurred (one month in arrears):
- by way of release of funding from the relevant Controlled Account; and
 - by way of a drawdown of the GLAP loan;
- in each case accompanied by all the required information as set out in the conditions precedent to drawdown in the facility agreement, including certification by the Monitoring Surveyor.
- 2.5 Borrower equity will fund all sums not funded by the Phase 1 tranche and the Phase 2 Tranche as required, in particular:
- loan interest
 - cost overruns, and
 - the amount by which the staged payments received from the registered provider to finance the costs of development of the affordable housing dwellings do not meet the costs actually incurred by the Borrower in delivering such affordable housing dwellings.

Financial Covenants:

- 2.6 The covenants are split by phase and are not cross-collateralised. Each phase is required to stand on its own.

Loan to gross development value (LTGDV):

- 2.7 This covenant is in place for facility sizing and drawdown caps, it is restricted to 55% of the gross development value of the unsold private and commercial units (less any receipts accrued to date and standing to the balance of the controlled account – see paragraph 2.21 below in respect of this account) for the relevant phase. The GDV is to be revalued on a yearly basis at the borrowers' costs.
- 2.8 The borrower will benefit from cure rights, by way of repaying the loan or injecting equity, should the outstanding balance of the loan represent more than 55% of the GDV as defined above.

Running loan to cost (drawdown restriction):

- 2.9 This financial calculation acts as a restriction on drawdowns. It is determined as:

A: If a land acquisition cost occurs in the subject month, then the lesser of 100% the market value of the Land or 100% the price paid for the land, plus any SDLT paid (For the avoidance of doubt the land value shall be split into a phase 1 and phase 2 land value); plus

B: 90% of the Total project delivery costs in the subject month (including any finance fees but excluding interest/and land/SDLT); less

C: the affordable housing receipts in the applicable month

i.e. $(A + B - C) * 70\%$ = the monthly GLA drawdown

In the event that during the subject month there is a positive cash balance in the relevant phases Controlled Account, then this account balance will be used in lieu of Higgins Equity (with any shortfall topped up from Higgins Equity).

Fully funded scheme test:

2.10 This test effectively seeks to ensure that Higgins benefits from sufficient equity to fund the project by interrogating their latest accounts and project cashflow.

2.11 The GLA will need to be satisfied acting on advice of the Monitoring Surveyor, that the aggregate of:

- The undrawn amount of the GLA facility
- The capital reserves of Higgins Group Plc*
- Any contracted but unspent affordable housing receipts
- Any contracted but unspent NHS Fit Out receipts
- Any credit balance (comprising net private and commercial sales receipts and/or Affordable Housing receipts) held in the Controlled account

Is not less than the aggregate amount of the Gross Development Costs which have been incurred but not yet paid and the Development Costs that have not yet been incurred, in relation to the scheme relevant phase.

*The Capital Reserve of Higgins Group plc will be calculated in reference to the most recent audited/management accounts, and provided and signed by a Higgins Group plc director.

2.12 Any failure to meet the fully funded scheme test will result in a default.

Repayment principles:

Repayment of the principal:

2.13 Prior to practical completion ("PC"), as certified by the GLA monitoring surveyor, 75% of net sales receipts from the commercial and private residential units will be used to repay the GLA Facility during the development period.

2.14 The residual net sales receipts, and any affordable housing surplus (i.e. where the monthly affordable housing receipts from Octavia Group under its forward purchase agreement with the borrower exceed the monthly project delivery costs for delivery of the affordable housing dwellings) will be held on reserve in the controlled account and released to fund qualifying development costs in line with the drawdown claims process.

2.15 After PC, 100% of net sales receipts from the commercial and private residential units will be used to repay the relevant phase's GLA loan. Post PC, GLA will also be entitled to sweep any positive cash balance in the relevant phases Controlled Account in order to repay the subject phase's GLA loan.

Repayment of the interest and fees:

2.16 The interest will be calculated on a monthly basis and paid from developer equity on a monthly basis. It will not be capitalised.

2.17 An arrangement fee of 1% will be charged on first drawdown of each facility, rolled into the loan and repaid similarly to that of the loan principal. Interest will accrue on the rolled arrangement fee.

Loan security:

2.18 As is standard for a senior debt facility, the GLA will benefit from a first ranking legal charge on the land required to deliver phase 1 and phase 2 once such land is transferred to the ownership of the borrower, along with collateral warranties (including step-in rights) from each sub-contractor or consultant with material design responsibility. This is applicable to both phases.

2.19 Phase 2 works will commence before the ownership of the land is transferred to Higgins (phase 1 PC triggers the land payment for phase 2 in the development agreement with LB Wandsworth). As a result, the GLA will not allow the phase 2 facility to be drawn down until the transfer of ownership occurs (and the charge over Phase 2 is in place). Higgins has accepted this principle and will fund phase 2 from equity until then.

2.20 Higgins Group PLC will also be providing an uncapped performance guarantee, which provides added protection should Higgins Homes PLC become insolvent by requiring Higgins Group PLC to step in and complete the applicable phase.

2.21 Finally, the GLA will benefit from a first ranking fixed charge and sole signing rights over two controlled accounts in the name of the borrower (one for each phase) into which all private residential and commercial net sales receipts and monthly surplus affordable housing proceeds (being the amount by which the staged payments received from the registered provider to finance the costs of development of the affordable housing dwellings exceed the costs actually incurred by the borrower to date in delivering such affordable housing) from the relevant phase will be deposited. Drawdowns against the credit balance of this account will follow the same monitoring surveyor certification process as loan drawdowns.

2.22 The GLA will also have a floating charge over two costs accounts in the name of the borrower (one for each phase) over which Higgins Homes Plc will have sole signing rights. These accounts are for development purposes and will be used to fund development costs, pay contractors and professionals etc. The GLA loan proceeds, affordable housing sales receipts and borrower equity required to meet development costs and interest payments will be paid into the relevant costs account.

3. Interest Rate Setting

3.1 The proposed interest rate of 6% has been recommended following the interest rate setting matrix below to determine the margin for risk, in line with the methodology used for other Land Fund facilities and recommended by the Interest Rate Setting Board and Land Fund Investment Committee.

3.2 In line with commercial lenders, the GLA sets its rates according to the following principle:

Offered rate = Lender's cost of funds + margin for risk + costs (if applicable)

Creditworthiness		Collateralisation		
		<60%	60-70%	>70%
(AAA - A)	Strong	0.60%	0.75%	1.00%
(BBB)	Good	0.75%	1.00%	2.20%
(BB)	Satisfactory	1.00%	2.20%	4.00%

(B)	Weak	2.20%	4.00%	6.50%
(CCC)	Very Weak	3.10%	5.25%	8.25%
(Below CCC)	Unsatisfactory	4.00%	6.50%	10.00%

- 3.3 For the lender’s cost of funds, previous loan transactions at the GLA have used the European Commission (“EC”) reference rate or the Public Works Loan Board (PWLB) rate, the GLA’s default source of finance, following advice from the GLA’s Chief Investment Officer. On the basis that this methodology for calculating a market interest rate (in particular by checking for each transaction that the lender’s cost of funds is not below the EC reference rate) should, on a risk-based approach, comply with State aid rules.
- 3.4 Following the UK’s departure from the European Union and the introduction of the new UK subsidy control system from January 2021, which has replaced the EU state aid system, and in the absence of Government guidance on subsidy control compliant base rates, it is proposed that the GLA adopts the same methodology as previously used to calculate the EC reference rate (now referred to below as the GLA reference rate) and continues to ensure that the “lender’s cost of funds” figure is no less than this rate. In this instance, it is proposed that the GLA uses the PWLB rate for the lender’s cost of funds. The current PWLB rate (5 year maturity, with fixed rate) is 1.16. Using the PWLB rate has the added advantage of providing added margin for prudence given the uncertainty in the current subsidy control regime: the GLA reference rate stands at 0.12 (and is therefore 1.04 percentage points lower than the PWLB rate).
- 3.5 The recommended margin applied is 4% based on the creditworthiness of the counterparty and the level of collateral offered. The creditworthiness of the counterparty is discussed in detail in previous sections of this document, but follows a “B” rating from Creditsafe, which has been translated to a “weak” counterparty in the matrix above. The collateral offered falls between 60 and 70%, with a LTGDV of 55% and running loan to cost of 70%.
- 3.6 The costs will not be added to the interest calculation as these are to be paid directly from the counterparty via undertakings.
- 3.7 The overall interest calculation is summarised here:

	Assumption	Basis Points
Cost of Funds	PWLB 5-year maturity fixed-rate	116
Risk Margin	Weak creditworthiness/Normal Collateral at 70% LTC	400
Additional Margin	To account for the nature of the transaction (namely the funding of land as well as development costs).	84
	Total Rate:	600 (6%)

4. Risks

- 4.1. As with any development finance loan, the key risks are linked to the performance of the development, which are exposed to revenue and cost inflation risk.

- 4.2. The projected returns provided by the developer are moderate (12% on cost, and 16% on private GDV) but in line with those assumed in the red book valuation obtained for the site.
- 4.3. Avison Young has been commissioned (at Higgins' cost) to carry out a full scope review of the terms, model, and a red book valuation of the underlying assets which provides added assurance that the terms are market facing and risk and returns commensurate with the proposition.

Revenue risk:

- 4.4. As it stands, based on the developer's latest model, it would take a 16% decrease in private values for the project to break-even. The values (land and GDV) have been underwritten by a red book valuation, and the facility size will be adjusted in line with the LTGDV should there be any downward revaluation of the private and commercial units.
- 4.5. It is also worth highlighting that the revenue section is partially de-risked since the development comprises 45% Affordable Housing and the contract negotiations with the Registered Provider (Octavia Housing) are significantly advanced for phase 1 and an offer provided for phase 2. GLA will not be allowing drawdowns to Higgins Homes PLC until an affordable housing contract is in place for either phase as a condition precedent, and once the fully funded scheme test is satisfied.

Cost inflation risk:

- 4.6. The construction costs for phase 1 are relatively ascertained given Higgins' expertise as a housebuilder, the technical due diligence carried out on the site, and the market testing of sub-contractor packages. There remains a construction inflation risk for phase 2 given the length of the project, however this would be the case of any medium term multi-phased development project and cannot be mitigated (albeit it could potentially be offset by inflation in private sales should this materialise over time).
- 4.7. As it stands, based on the developer's latest model, it would take a 20% increase in construction costs (across both phases) for the project to breakeven. Similarly, it would take a 40% increase in construction costs in phase 2 only for the overall project to breakeven.

5. Legal Comments

Subsidy

- 5.1 It is the GLA's intention that the terms and conditions and the interest rate for this proposed loan to Higgins Homes plc is in line with those available on the open market. On that basis the GLA proposes to rely upon the principle that public bodies may lend to enterprises/economic actors on terms and conditions which would be acceptable to a notional private lender operating under a normal market economy situation. Provided the principle is properly complied with then no subsidy should arise as no economic advantage is conferred on the loan recipient.
- 5.2 Previously, under the State aid system, this principle was referred to as the Market Economy Operator Principle (MEOP). In the absence of UK regulations at the current time in respect of the new subsidy control system – and noting that the EU/UK Trade and Co-operation Agreement (TCA) under which the subsidy control rules are currently set out applies to the EU's State aid system as well as to the UK - there is a reasonable argument that if State aid principles are followed then there should not be a breach under the TCA. On this basis, following the same rationale as MEOP, the onus is on the public authority to justify (and if required prove) that:
- 5.2.1 The terms/conditions of the loan and interest rate are market terms for the particular circumstances of each transaction;
 - 5.2.2 A notional market lender would have lent to the particular loan recipient (e.g. they were creditworthy); and

5.2.3 The terms of the loan properly reflect the security being offered.

5.3 It should be noted that in applying the proposed GLA reference rate methodology for calculating a market interest rate, the GLA is adopting a risk-based approach; by applying the methodology there is a reasonable argument that the loan would be compliant with subsidy control rules, though there is still a risk that not all will be.

5.4 Circumstances where unlawful subsidy may still arise when using the proposed methodology include:

5.4.1 No market lender would have lent to the loan recipient (e.g. bad credit score or insolvency concerns);

5.4.2 Not applying the methodology as a notional market lender would (e.g. accepting poor security but scoring it as strong security);

5.4.3 Not commercially assessing and/or applying the credit scoring; or

5.4.4 In effect treating the application of the methodology as a process, rather than a tool to determine the correct market rate for the particular circumstances of each loan.

5.5 It is advised that the following steps should be followed by the GLA to help mitigate against these risks:

5.5.1 Ensure that the credit rating is current and from an independent respected organisation;

5.5.2 Properly consider any security being provided (including what is the market value of the assets being secured and order of priority of its security); and

5.5.3 Undertake a more detailed review of difficult cases, particularly if there are concerns that a notional market lender would never lend (e.g. insolvency concerns about the borrower).

5.6 GLA officers have confirmed that the above mitigating measures have been followed and external lawyers are being instructed to prepare and negotiate the funding contracts and security documentation for GLAP, including the incorporation of any provisions required to ensure compliance with subsidy control rules.

5.7 It is proposed that the GLA charges a fixed interest rate for this loan. Following the same principles as MEOP, a loan with a fixed interest rate would be acceptable provided it complies with the requirements set out in paragraph 3.2 above. To rely upon this the GLA should obtain evidence from a suitably qualified commercial/financial adviser that at the time the loan is to be granted a notional market lender would offer the proposed fixed interest rate to the relevant borrower in identical circumstances. Such evidence would have to take into account the creditworthiness of the borrower, security offered and the identical circumstances of the proposed arrangement. GLA officers have confirmed that this evidence has been provided by Avison Young in relation to the proposed loan to Higgins Homes plc.