

PART 2 – CONFIDENTIAL FACTS AND ADVICE

DD2160

Title: HEART OF HARROW HOUSING ZONE (LB HARROW)

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The information below is not for publication until the stated date, because:

It contains commercially sensitive information the disclosure of which might prejudice the commercial and business interests of GLA Land and Property Limited. It also contains legally privileged information.

Date at which Part 2 will cease to be confidential or when confidentiality should be reviewed: 31 March 2021.

Legal recommendation on the grounds of keeping the information confidential:

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 scheme and unit costs of housing relating to the intervention and proposed GLAP funding; the proposed structure and terms of GLAP funding; and confidential information relating to the proposed recipient 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. Whilst 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 material, including legal advice relating to the commercially sensitive information, which it is in the public interest to withhold.

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

Name

Date

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

Confidential decision and/or advice:

Appraisal

- 1.1 Project due diligence was undertaken by Lambert Smith Hampton (LSH) using a Housing Zone Development Appraisal Toolkit and information provided by the counter-parties and a valuation report provided by Savills. The abovementioned information provided includes the build cost for both the private and affordable units. The private units are estimated to be £186,443 per unit or £211 per sq ft. According to LSH and their knowledge of the current construction market and comparable schemes, LSH find this an acceptable build cost. Similarly, for the affordable unit build cost, they equate to £208,661 per unit, or £195 per sq ft. according to LSH this is reasonable and the increase in cost per unit is due to the larger unit size for the affordable units.
- 1.2 The residential sales price within the private unit cash flow reflects a sale price per sq ft of £590. LSH have identified this number as being optimistic. This assessment is based on a range provided on the Savills report of between £530 - £564 per sq ft. In addition, LSH have done a comparison of a number of comparable sales within Harrow. Overall, the sales evidence per sq ft suggests that the market reflects low £500 per sq ft for the private units.
- 1.3 The development period for the project cash flow for both Loan 1 and Loan 2 starts in December 2016, and has the following key dates:
- Site purchase December 2016;
 - Build programme March 2017-June 2019; and
 - Sales period April 2019 – July 2019.
- 1.4 The development period for both loans project cash flows starts in 2016/17 and in respect of development spend and the anticipated completion of housing units, ends in 2019/2020. The final sale of housing units occurs within this development period.
- 1.5 The GLAP loans, together with accrued interest, is to be repaid as follows:
- The developer shall pay accrued interest on the loan on 31 March and 30 September each year (and on the final repayment dates; and
 - The loan must be repaid on the earlier of; 5 years from the date of the agreement and the date being 20 business days from the date of disposal of the last dwelling.
- 1.6 LSH's due diligence incorporates project appraisal, comparable analysis of the proposed development costs and reviews of delivery milestones. Having reviewed LSH's assessment report, officers of GLA Housing and Land approve its findings and deem them to be sufficiently robust to justify GLAP Investment into the project.

Legal Comments

Contracting Party/Security/Exit Routes

- 2.1 External lawyers have prepared and advised on the draft Development Facility Agreements and other contractual documents. Below is a summary of the agreement.
- 2.2 The GLA will have the following security in relation to the two loans:
- Loan 1: debenture over JV's assets, which as the JV has just been set up and will apply to site value and WIP. OHL have a fixed first charge over the site and WIP, the GLA have the benefit of this charge.
- Loan 2: The GLA will have the benefit of a first, fixed charge over the leasehold interest and step-in rights into the affordable agreement. The GLA will need a fixed charge referred to in Loan 1 to remain in place until the loan is repaid as a charge over the leasehold interest and step-in rights into the affordable contract would not in itself give the GLA security over WIP and monies owed. In summary, both Loan 1 and Loan 2 are secured against the value of the site and WIP (90%). We detail below the milestones of the project (from information provided) and the WIP expended on these points. Drawdown of funding is as required as per the construction programme and therefore the WIP should cover the cost of the loan (as 60% of costs are loaned by the GLA). However, the closer to completion the lower the risk profile for the GLA.
- 2.3 The entities on both loans are obliged to provide a monthly report to GLAP containing updated information about the scheme and its progress. Similarly, the counter-parties for each loan will also provide annual and management accounts to GLAP. The monthly report will, amongst other things, include computations as to compliance with the financial covenants in the agreement which are as follows:
- The developer must ensure that the ratio of the advanced funding to the aggregate of the market value of the site plus WIP does not, at any time, exceed 60%;
 - The developer must ensure that the loan to value does not, at any time, exceed 55%.
- 2.4 An event of default occurs under certain circumstances. If this happens, GLALP has the right to enforce its security. These include (but are not limited to):
- 2.4.1 a milestone failure occurs;
 - 2.4.2 the Developer materially fails to perform and/or observe any obligation or restriction on it under any finance document or scheme project document;
 - 2.4.3 any representation or warranty or covenant made by the Developer under the Agreement is incorrect in any material respect when made or repeated;
 - 2.4.4 an event or circumstance occurs in relation to the Developer that could have a material adverse effect;
 - 2.4.5 a finance document not being, or ceasing to be, effective or not having priority;
 - 2.4.6 the withdrawal or revocation of a consent, which is likely to have a material adverse effect;
 - 2.4.7 cross default with other financial indebtedness of the Developer;
 - 2.4.8 failure to pay any amount due under a finance document, subject to a 3 Business Day grace period where non-payment is as a result of technical delay in the transmission of funds;
 - 2.4.9 GLALP in its absolute discretion (acting reasonably) considers that the Developer does not have sufficient funds or resources available to them to complete the works and the scheme in accordance with the scheme details; and
 - 2.4.10 insolvency events occurring in relation to the Developer .

Scheme Funding

- 2.5 The loan advanced by GLAP is to fund certain development costs in respect of the project including land acquisition costs, works and on costs. The development will comprise 116 units, of which there will be 69 market sale dwellings and 47 affordable housing dwellings.
- 2.6 There are a number of conditions precedent to be provided for both loans before any funding is advanced, which include corporate formalities, a scheme budget, a construction timetable, a valuation in respect of the site.
- 2.7 Both Loans must be repaid on the earlier of:
- (a) 5 years from the date of the Agreement; and
 - (b) The date being 20 Business Days from the date of disposal of the last dwelling.
- 2.8 The counterparties may on giving not less than 15 Business Days' prior written notice to GLALP, repay all or any part of either loan. Any partial reduction of the facility shall be at a minimum amount of £100,000 and in multiples of £100,000.
- 2.9 Interest will accrue and be paid every six months on 31 March and 30 September in each year. Interest shall accrue at the following fixed rates per cent per annum:
- Loan 1:**
- 3.84 per cent per annum.
- Loan 2:**
- 2.24 per cent per annum.

State Aid

- 2.10 It is GLAP's intention that the terms and conditions and the interest rate for this proposed loan to the counter-parties are in line with those available on the open market. On that basis GLAP proposes to rely upon the Market Economy Investor Principle (MEIP), which permits public bodies to lend to enterprises/economic undertakings on terms and conditions which would be acceptable to a notional private lender operating under a normal market economy situation. Providing the principle is properly complied with then no state aid arises as no advantage is conferred on the loan recipient.
- 2.11 The onus when relying on MEIP is for the public authority to justify (and if required prove) that its loan has complied with MEIP requirements. These include:
- 2.11.1 That the terms/conditions of the loan and interest rate are market terms for the particular circumstances of each transaction;
 - 2.11.2 That a notional market lender would have lent to the particular loan recipient (e.g. they were creditworthy); and
 - 2.11.3 That the terms of the loan properly reflect the security being offered.
- 2.12 External lawyers have advised the GLA as to whether the methodology for calculating a market interest rate set out in the EU Commission's Communication in relation to setting reference and discount rates (2008/C 14/02) (the Interest Rate Communication) is acceptable in respect of state

aid compliance. Their advice is that this methodology is widely used by public authorities in circumstances where they are making a market loan under MEIP but, in doing so, they are adopting a risk based approach; by applying the methodology it is probable that in most circumstances the loans would be state aid compliant, though there is still a risk that not all will be.

- 2.13 Circumstances where unlawful state aid may still arise when using the proposed methodology include:
- 2.13.1 No market lender would have lent to the loan recipient (e.g. bad credit score or insolvency concerns);
 - 2.13.2 Not applying the methodology as a notional market lender would (e.g. accepting poor security but scoring it as strong security);
 - 2.13.3 Not commercially assessing and/or applying the credit scoring; or
 - 2.13.4 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.
- 2.14 External lawyers have advised that the following steps should be followed by the GLA to help mitigate against these risks:
- 2.14.1 Ensure that the credit rating is current and from an independent respected organisation;
 - 2.14.2 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
 - 2.14.3 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).
- 2.15 GLA officers have confirmed that the above mitigating measures have been followed and external lawyers have been instructed to prepare and negotiate the funding contracts and security documentation for GLAP, including the incorporation of any provisions required to ensure compliance with state aid rules.
- 2.16 External lawyers have also advised on the ability of GLAP to adopt a fixed interest rate for its loans and whether this complies with the MEIP/state aid requirements. Their advice is that a loan with a fixed interest rate is acceptable under MEIP providing it complies with the requirements set out in paragraph 2.9 above. To rely upon this GLAP would require evidence that at the time the loan was granted a notional market lender would have offered the relevant fixed interest rate to that borrower in identical circumstances.
- 2.17 It should be noted that the Interest Rate Communication itself requires a variable interest rate. External lawyers have therefore advised that where a fixed rate loan is to be offered, the GLA would also require evidence from a suitably qualified commercial/financial adviser that a rate calculated using the Interest Rate Communication would also be offered in identical circumstances by a notional market lender for a fixed interest rate loan (or advise on the higher margin which a notional market lender would require). Such evidence would have to take into account the creditworthiness of the borrower, security offered and the identical circumstances of the proposed arrangement. External lawyers have advised that advice from an independent external financial adviser would provide the strongest evidence. However, GLA officers have confirmed that, in relation to the proposed loan to the counter-parties, this evidence has been provided by suitably qualified internal advisers. In so doing the GLA is accepting the risk that if the loan is ever challenged on state aid grounds, such

internal sign-off may not be viewed as sufficient objective evidence that the fixed interest rate is a market rate.

Finance Comments

- 3.1 The interest rate of 3.84% for Loan 1 and 2.24% for Loan 2 was confirmed by the Treasury team on the 2nd February 2017.
- 3.2 The costs and values that have been stated by the JV and RP have been deemed by Lambert Smith and Hampton as being within an acceptable range.
- 3.3 In arriving at the interest rates for this intervention, the IRSB has relied on the following interest rate grid as their margin for risk. Therefore, an organisation/project with Weak Creditworthiness and High Collateralisation attracts a margin for risk of 2.2%. This is a widely-used state aid grid, which is also used by the Homes and Community Agency (HCA).

Creditworthiness		Collateralisation	
	High	Normal	Low
Strong (AAA-A)	0.6%	0.75%	1%
Good (BBB)	0.75%	1%	2.2%
Satisfactory (BB)	1%	2.2%	4%
Weak (B)	2.2%	4%	6.5%
Unsatisfactory (CCC and below)	4%	6.5%	10%

- 3.4 In common with all commercial lenders, GLAP sets its rates according to the following principle:

Offered Rate = Lender's cost of funds + margin for risk + costs

- For lender's cost of funds, the State Aid Matrix or the PWLB (our default source of finance) rates are used, whichever is the greater.
 - For margin for risk, the Interest Rate Communication risk matrix is used, which has been specifically issued by the EC to comply with state aid; we have taken a professional view that it is indeed a reasonable framework (in the expectation of building up a diversified portfolio); as the portfolio evolves, we will keep this position under review, including from time to time commissioning external research, but would not expect to go below these suggested spreads.
 - The IRSB has decided that in relation to costs they will set this at the level of GLAP's legal fees.
- 3.5 For the lender's cost of funds, we use the cost of GLAP borrowing funds from the DCLG. This rate is currently 1.64%, this rate may fluctuate with movements in the EC reference rate, which is currently 1.04%. DCLG charges GLAP 0.6% on top of this, taking GLAP to be a counterparty of Strong Creditworthiness and High Collateralisation. Interest rates are fixed a point of borrowing in relation to DCLG and GLAP Housing Zone Financial Transactions.
- 3.6 The Chief Investment Officer or Assistant Director Group Finance certifies that the pricing principles above have been complied with and (following consultation with Legal Services) that the other terms and conditions of the loan are structured in a prudent commercial manner, in line with our MoU with DCLG.
- 3.7 Given that we judge our rate to be calculated in a commercial manner, and that we anticipate our contracts will contain the normal provisions found in commercial loans, we are satisfied we are meeting the requirements of the MEIP:
- GLAP lends "on terms and conditions which would be acceptable to a *notional private lender* operating under a normal market economy situation".

- 3.8. As an overlay, where we are dealing with companies with actively traded bonds, we would compare our rates to look for large discrepancies and seek to understand these. We

Appendix 1 – Northolt Road Cash flow

Appendix 2 – Summary of Property Due Diligence