Agenda Item 3.1 – Appendix 3

£40m Revolving Fund loan Programe

Impact of the Coronavirus on the CPCA £40m Revolving Fund Loan Book – Proposals for Restructuring of Facility Agreements

1. CPCA's Objectives – Delivery of Additional Housing Units

It is worth referencing the original reasons for the CPCA to create its £40m revolving fund which are embedded in its housing strategy approved by board in Sept 2018. The primary objective is to support and enable the delivery of additional housing units, both market and affordable. It was not to make money or profit, though if that could also be achieved as an outcome it would be welcomed, increasing the size of the fund over time for future investments.

2. How Covid -19 is Impacting So Far

Housing and construction businesses countrywide are opening up whilst also taking precautionary measures involving new working practices to avoid employees contracting Covid-19. A key issue and concern is about whether housing developers will be able to perform their contractual obligations and knock on financial and other implications for them.

Loans and real estate transactions

In supporting their borrowers, banks in the United Kingdom have introduced payment holidays and suspended loan repayment obligations during the coronavirus Covid-19 impacted periods. This is backed by a commitment by the UK government to guarantee loans to businesses in certain situations.

For construction and other real estate transactions, cash flow for financing projects and for servicing any development loans is being severely constrained. Shortages and lower efficiency of labour may also pose a problem as employees have to adhere to new social distancing rules on site. Shortage of supply of certain building materials is an added concern that is starting impact upon anticipated pre-covid delivery programmes. There is a real probability that contractors will be unable to complete construction projects within agreed timelines, rendering developers in potential default of their obligations to project lenders.

Loans and real estate contracts usually permit the parties to renegotiate the terms of the contract where changes in circumstances arise. This is typically the preferred way to mitigate a project arising from significant changes in circumstances. It is therefore anticipated and there are indications now appearing from the market that many property lenders and borrowers will pursue debt restructures and variations to existing facility agreements in order to help developers to complete their developments in this new environment.

It is too early to comment on the long term effects of Covid-19 on property lending but we are aware that senior lenders (banks like Lloyds, Barclays and RBS) are still principally focusing on supporting, by extending terms and lending amounts to existing clients as part of the support required to still enable successful project outcomes. I understand they are however largely avoiding new deals for now.

In the construction sector, pricing is being impacted by supply chain issues. We expect there to be an inclination towards 'open book' pricing due to extent of 'unpriceable unknowns', problems sourcing materials and global supply chain disruption. So the developer may carry the risk, not the contractor, requiring more financial flexibility and bigger contingency sums.

Post 2022, inflationary Construction costs pressures are anticipated to increase as full recovery comes on line. There is also potential for an increase in labour costs under the new points based immigration system.

M&G's Head of Property Lending John Barakat stated on 1st June that ''I will be shocked if anyone emerges from this unscathed''.

Some banks in Germany are reported to be using borrowers covenant breaches to increase interest rates (reported end May).

City University of London Business school predicted in a report on 22nd April ''that £22 billion of development loans face delays and losses and write-off's could reach £10 billion''

Redrow, one of Britains biggest housebuilders has been reported to be in negotiation with six banks for financing support due to the impacts being felt due to Covid-19 and is also seeking to secure funding from the government under an emergency state aid package for businesses. "These are unprecedented times," Executive Chairman John Tutte said, "The actions we have announced today will give us the flexibility to manage the business through this turbulent period''.

On 18th May 2020 the Scottish Government has launched a £100 million Emergency Loan Fund for Scottish SME housebuilders with liquidity issues due to the temporary closure of the housebuilding sector. The fund's aim is to safeguard jobs and protect suppliers, ensure a continued supply of homes, support post-COVID-19 economic recovery and retain diversity within the housebuilding sector.

The fund offers short-term loan funding to applicants to cover three months of liquidity support to their business.
The key terms of the loans are:

- Loans of between £50,000 up to £1 million will be available
- Majority of loans expected to be repaid within 24 months
- Fixed interest rates set at 2%
- Security on loans will be assessed on a case-by-case basis, which will help improve the risk profile for the Scottish Government.

In May 2020 regional housebuilder Aquinna Homes has been able to support its future with a multi-million-pound Coronavirus Business Interruption Loan Scheme (CBILS) loan from Lloyds Bank. The business employs 25 people and with Covid-19 bringing an abrupt halt to the housing market, the company turned to longstanding banking partner, Lloyds Bank, for support, securing a seven-figure CBILS loan.

Stephen Brazier, founder and managing director at residential developer Aquinna Homes, said: “Current circumstances are affecting developers….It’s uncertain how quickly demand will return and this funding, together with the renewal of the revolving credit facility, will not only enable us to re-start quickly once the lockdown is eased but support the company until consumer confidence returns. Importantly, the RCF will also allow us to keep buying land so we can build new homes in the future and keep the business moving. All this has been possible thanks to the team at Lloyds Bank.”

In June 2020 housebuilder Rural Renaissance Limited (RRL) has secured a six-figure funding package from Bank of Scotland to support its working capital, enabling it to continue to pay suppliers and honour its contractual commitments during the coronavirus crisis.

The funding from Bank of Scotland has safeguarded 35 jobs for the future, with the company eager to commence three new development projects once lockdown has ended.

Michael Crawford, managing director at RRL**,** said:
“We were set for further success this year until the COVID-19 crisis hit. As with many other businesses, much of our activity is now on hold.
“The team at Bank of Scotland has been by our side, helping us navigate our way through our cash flow challenges, ensuring we have the financial headspace needed to continue to trade.’’
Douglas Spowart, relationship director at Bank of Scotland, added: “RRL is an example of a business that has performed well over the past decade and had a promising year ahead of it. The coronavirus crisis brought everything to a standstill, meaning Michael and his team needed additional support.
“We’ve worked with RRL to put a package in place that, critically, the business can afford to repay. The funding has secured the future of the business.”

For loan facilities, there are concerns about borrowers’ ability to meet their repayment obligations. Typically under borrowing agreements, a failure to meet the obligations to repay a loan facility constitutes an event of default, invoking a lender’s right to exercise its remedies towards recovery of the entire outstanding debt. In the prevailing circumstances, especially with the possibility of further intermittent lockdown, moving for recovery will be more challenging if lenders find themselves having to exercise their statutory power of stepping in and sale or other remedies. Such action is highly likely to be more damaging as it results in additional disruption to construction contracts and programmes and usually results in programme delays and increased costs when compared to supporting borrowers through the current uncertainty, especially if the primary objective is to get the residential units successfully delivered.

It is also very likely that any lender moving to aggressively recover a debt will incur a dent to their public image and perception as being overly aggressive and unfair.

Our Borrowers are in the process of planning and initiating the full re-start. They have revised their development programmes, appraisals and cashflows to reflect the new situation and to still successfully deliver the development of the housing units.

3. What sort of actions or interventions could CPCA consider?

1. **Do nothing –** The implications of this cannot be clearly predicted, but the potential types of scenarios might look as follows ;
    - If the project has not yet been fully started/committed, it is unlikely that the developer would be able to start without knowing that he has funding for a sufficient period to complete the development, as no contractor would take this on. So the borrower would have to look to sell the site before the facility agreement expires and look to repay any money drawn down from the sales receipt. No new housing would be developed for the foreseeable future.
    - If the borrower has started beyond the point of no return, then they may try to sell the site ‘’as is’’ or whilst construction is ongoing. They will most likely re-programme the works to only finish building what they have enough time to complete and leave the remainder to be sold and maybe developed by a purchaser at a much later date.
    - The borrower may have no obligation but to progress, but in the knowledge that they will have to re-finance in order to be able to complete the development. This will carry significant risk and potentially high costs. If re-financing is not available, the borrower will default and the lender will be left to pick up a partially constructed project. Normally there are disputes, costs and time escalate and the project outcome is rarely satisfactory.

2. **Support our borrowers with a package of interventions to increase the likelihood of housing delivery and successful re-payment of loans**

    - The most critical measure is to extend the duration of the loan in order to enable the borrower in the anticipated ‘Covid’ environment to successfully complete the construction of the development and sell the units.
    - Ideally the financial ‘’metrics’’ should not be changed from those when the loan was granted, for example no change to the proposed interest rates being applied, provisions for any profit share etc.
    - The borrower is incurring other additional costs to complete the planned development as a result of the Covid outbreak that are having a negative impact on the projected financial out-turn. This maybe affecting their commercial decision/s to either commence or continue with the development if risks have increased and the normal level of expected returns may not be achieved. This will be putting the delivery of additional houses at risk. then consider any additional measures like an ‘interest holiday’ to keep the borrower motivated to deliver the development. If the risk/reward profile

worsens, there will be an increasing risk of the project not proceeding.
- Objective – put an appropriate set of measures in place, so the borrower will be encouraged and confident to keep building the scheme out as originally planned.

3. Use the Borrowers potential distress as an opportunity to improve the deal

- Some lenders might view the borrower's predicament as an opportunity to increase their margin by increasing the interest rate in return for an extended lending facility. Justification might be because of an increase in the perceived risk. However, by increasing the borrower's costs there is a greater chance of 'creating a self-fulfilling prophecy' in that it reduces the developers margin and increases the chance of the development failing and the borrower defaulting, or the scheme just not being progressed and built.

3 What are our Borrowers Asking For?

The good news is that all of our Borrowers are indicating that they want to proceed and complete their developments, delivering the new housing schemes as originally intended.

They have been in the process of implementing and preparing for full project re-start. They have revised their development programmes, appraisals and cashflows to reflect the new Covid situation, to still successfully deliver the developments.

As a result, they have identified specific requests for each project to extend the duration of the facility agreements and further financial support through requests for interest holiday periods. There is also a request from ECTC on the MOD Ely scheme to change the method by which interest is calculated from a compounded to simple basis.

The table in Appendix 1 summarizes the current facility terms and what is being requested as a variation by the developer for each project.

Appendix 2 shows the previously anticipated cashflow profile of the £40m revolving fund and the new profile in the event that the borrowers requests on each project are agreed. As expected, anticipated repayments are delayed and the maximum drawdown is projected to rise to £40.1m in March 2021 before then steadily falling.

Interest free periods are being requested. We will seek to apply a claw back condition. So, for example, if the final project outcome returns to the level of profit that was originally projected when the loan was first granted, then the full amount of interest as originally intended would still be paid. Effectively we are saying that if in hindsight the interest free period was not required, then the interest as originally anticipated and being due will be paid. Calculation of the claw back of interest will be in direct proportion to the relationship between development profit that was projected when the loan was first granted, and the projected revised profit as a result of the Covid-19 impact.

These variations can be documented through variation to each of the existing facility agreements.

State Aid Implications – Private Creditor Test

Under State aid law, varying the terms of a state funded loan to the benefit of the debtor is potentially aid, as this is an advantage flowing from state resources. Housebuilding has been regarded as an area where there is a potential impact on trade between EU member states. The Private Creditor test is an aspect of the more general Market Economy Operator Principle, which identifies that where a public body is acting in the same way as a private market operator could reasonably be expected to act, there is no aid, as on comparable facts the private sector would give similar benefits.

Applying this to the current situation, it is apparent from the factual background above that the market of development funding is supporting existing schemes by allowing interest variations and loan extensions where satisfied this is a sensible approach on the facts. Here it is suggested that the approach can be applied and will be lawful as long as we are satisfied that the developments where support has been requested are sufficiently viable for the support to improve the likelihood of recovery over a non-intervention stance. In this context it is suggested that careful consideration is given to the suggest in section 3 above that there is a claw back arrangement if the development returns to the original levels of profitability.

Appendix 1 - Summary of existing schemes and developer requests

Appendix 2 - £40m revolving fund cumulative cashflow graph

<u>Credentials:</u> The author of this paper Roger Thompson is the Director of Housing and Development at CPCA, is a Member of the Royal Institution of Chartered Surveyors and has 34 yrs experience of working in the property industry. Between 2007 and 2012 Roger ran a team at EC Harris that supported and advised Lloyds and RBS about strategies and support for property lenders/borrowers as a result of the credit crunch which included team members being seconded into the banks.