# Submission Relation to EXD/079

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**Summary of Key Points**

- The Homes England letter shows the relevance of State Aid in any scenario where a public sector entity (government, Homes England, councils etc) is lending to a developer, public or private
- The letter makes no comment on the GCs, NEGC, willingness to lend or potential borrowing rates; obviously it could easily have done so
- The PWC report remains highly relevant (no justification to the contrary having been provided) – its assessment of a State Aid compliant 11% nominal finance rate for a debt-financed project (as would be the case for NEGC Ltd or a public-private partnership) is based on the very EU Commission table provided in EXD/079
- Dr Sam Fowles' legal opinion further supports the importance of State Aid being considered in a viability and delivery context at this stage in the Local Plan process; it entirely undermines the broad-brush NEA and NEGC attempts to dismiss the significance of State Aid at the EiP
- For NEGC/successor/LLNTDC (or indeed a public-private partnership), our analysis – supported by PWC and a credit expert, Mr Charlesworth (Appendix A) – indicates a State Aid compliant nominal finance rate would be 11%; we refer to the PWC paper and Dr Fowles' legal opinion that this cannot be "remedied" with a guarantee structure as the State Aid implications would be unchanged.
- NEGC's anecdotal comments at the EiP regarding potential borrowing rates, including borrowing directly from government without State Aid implications are at best unsupported by any evidence, but in reality are legally and economically flawed
- Large private sector developers can finance their corporate balance sheets at levels below 6% (and if doing so just from the debt markets will not have State Aid issues)
- However, corporate level borrowing and project level borrowing are very different: developers have balance sheets of 25-35% debt and the rest equity – this means they must generate suitable returns on the equity component if on-lending to projects, hence required IRRs in the 12-20% area
- The Avison Young analysis for NEGC (Hyas IRR analysis is circularly meaningless as we explained at the EiP) shows 300dpa IRRs in the 3-6% range for WOBGC and CBBGC (although these IRRs would actually be lower still as the NEGC land acquisition figures are too optimistic) and therefore it is not surprising that developer viability analyses have "low and slow" infrastructure to boost returns to the sort of range they expect. We continue to assert strongly that the Plan / its policies are not shown to be viable for any developer type including private sector

The short Homes England paper included in the evidence base at EXD/079 was included by NEGC Ltd in order to attempt to justify a borrowing cost of 6% or under for NEGC Ltd (or a successor structure) acting as a master developer in relation to one or more of the proposed garden communities, in response to the Inspector's question at para 70 of IED011 (June 2018).

It is important to identify first what this letter (and its inclusion) does and does not do:

- **It DOES show through its inclusion a clear recognition that there is significant risk around State Aid rules in any scenario where NEGC Ltd or a successor entity (including an LLNTDC) or a private sector developer (or a combination thereof) receives financing from any public sector body on favourable terms**

- **It DOES NOT in any way validate the garden communities or NEGC Ltd's approach to them**. It could of course have commented to such effect

- **It DOES NOT make any representation that it will offer financing (even a preliminary representation)**. Again, it could of course have done so

- **It DOES NOT comment on a potential - even theoretical - financing rate for NEGC Ltd or a successor entity** acting as master developer: the reader of the letter is left to assess this using the table provided. Again, Homes England could have commented on this.

Having established that **the letter does not itself directly or clearly address the Inspector's concern around the financing rate used for viability modelling**, three key topics merit consideration in relation to this document in an attempt to derive meaning in context.

A. Clarity around State Aid in relation to the NEA Local Plan examination

B. Clarity around implied financing rate for NEGC Ltd or a successor entity acting as master developer (including in an LLNTDC context)

C. Clarity around relevance for finance rate and viability implications for other delivery mechanisms

We will consider these points in more detail below:

**1. Clarity around State Aid in relation to the NEA Local Plan examination**

The PwC document - or at least the redacted version provided to the examination - **is clear that State Aid is a significant risk where there is direct state-linked/public sector involvement in financing the delivery of the garden communities**. While there have been assertions that the report now lacks relevance as 'things have moved on', there has been no explanation - written or meaningfully at the EiP - as to why this is the case. **Our view is that the PWC report remains of the same relevance as when the Inspector posed his question** (IED011 para 70).

Meanwhile **Dr Sam Fowles in his legal opinion submitted as a response to EXD/079 also confirms the relevance of State Aid where there is any financing provided by the government / the public sector at favourable rates**. This opinion is of particular significance since there were rather hastily made assertions at the EiP by the NEAs and NEGC Ltd - inconsistent with the evidence base - that State Aid was simply of no relevance in any context; it is clear that **such a summary dismissal is entirely flawed and represents a worrying lack of understanding of a critical part of approaching a Local Plan via the potential for a public sector-led delivery mechanism**.

Indeed the somewhat absurd nature of the position which the aforementioned parties attempted to express at the EiP is simply revealed by posing the question: **if State Aid is not relevant, then why did NEGC Ltd submit this letter and why does Homes England in this context have a working knowledge of State Aid financing implications?**

**We strongly assert not only that this area has not been addressed appropriately (indeed virtually not at all) in response to the Inspector's letter, but also that this constitutes a standalone reason for lack of legal soundness of the Local Plan** as things stand. We furthermore note that comments along the lines of 'it would be surprising if this were the first Local Plan to be found unsound on the grounds of State Aid' are part of a broader pattern of **a lack of understanding from the NEAs and NEGC Ltd of the complex and unprecedented nature of these projects**, which after all are not only the largest of their kind in the country today but also the **most complicated and untested from a delivery mechanism perspective** – it is hardly surprising that this topic is critical here.

2. **Clarity around implied financing rate for NEGC Ltd or a successor entity acting as master developer (including in an LLNTDC context)**

**All viability modelling has been carried out on the basis of 100% debt financing**. We comment on this in (3) below as it is relevant in the context of other structures and was raised at the EiP as a common simplification in viability modelling.

However, in the context of NEGC Ltd or a successor entity (including an LLNTDC) acting as master developer, **there is actually nothing which suggests that this would not likely be the proposed 'capital structure'** (capital structure being the mixture of debt and equity used for financing), for these would be standalone development projects and all commentary from NEGC Ltd has pointed to such a structure.

The Homes England letter is almost an ironic inclusion in the evidence base, when it is considered that the NEAs and NEGC have been trying to distance themselves from the PWC report: **for the 10% margin referred to in the PWC report is explicitly related to the very same EU guidance which Homes England refer to** (the difference being that PWC have a detailed understanding of the projects in hand and make the assessment accordingly; Homes England make no assessment in relation to the actual project(s) hand).

Aside from the PWC report concluding that a finance rate would be c.11% nominal / 9% real (~1% base rate + 1000bps margin = 11% minus 2% inflation estimate = 9%), we refer to the comments of Mr O'Connell at the EiP for Matter 5 and also to the important attached paper (Appendix A) from Mr Charlesworth who is a hugely experienced credit risk expert. **Both of these assessments reach(ed) the same conclusion as the PWC report regarding the EU-compliant finance rate of 11% nominal**. We note for completeness that none of the Homes England borrower examples cited are of relevance to a public sector master developer taking on a discrete project (but we cover this point further in (3) below).

For good order as some developers seemed confused on this topic at the EiP, we note that the PWC report and Dr Fowles' legal opinion (as well as previous submissions from Mr O'Connell) highlight that **there is no difference from a State Aid perspective between direct financing from a public sector entity and private financing with a public sector guarantee** – in both cases the "all-in" cost (i.e. including guarantee cost) is what is considered.

We observe that **the EiP (Matters 5 and 7) was littered with a number of anecdotal reports from NEGC Ltd around potential financing structures and confidence around financing rates (all bizarrely recent, seemingly between the evidence submission dates and the EiP) but it will likely be clear that this is not represented with any clarity (or indeed at all) in the evidence base and lacked details and robustness at the EiP**. We would note that the lack of clarity or potentially fully formed understanding was surprising given the scale and complexity of these potential allocations. The worst example was probably the idea expressed that NEGC (or successor entity, or a public-private partnership) might borrow directly from government without State Aid issues – this is patently not feasible. We make reference also to Mr O'Connell's previous submissions on **the danger and indeed lack of relevance of such (respectfully) half- or quarter-baked plans and discussions** – it is clear that little or no weight can be given to such anecdotal evidence.

3. **Clarity around relevance for finance rate and viability implications for other delivery mechanisms**

Private sector developers were at pains during the EiP to note that there were no state aid issues relating to them raising private debt financing to take the projects on with no public sector involvement in delivery or financing. This is - of course - entirely correct assuming there is no Council or other public sector involvement whatsoever in their borrowing (see Dr Fowles' legal opinion on this point).

Indeed, the examples of financing recipients (e.g. Urban & Civic) quoted in the Homes England letter are cited in a State Aid context because they are borrowing from Homes England, which is a state-linked entity, and there is the risk of these recipients borrowing at terms which are favourable vs. what is achievable in the debt market. State Aid would not be relevant if the same borrowers were being financed by the debt market.

**It must be remembered that this discussion is in the context of the Inspector's question: whether 6% real finance cost is justified in the context of the viability modelling**. The viability modelling is 100% debt based and has been treated as a standalone project**. If we are to examine a private developer lending to the project from its broader balance sheet (ie relying on its wider credit standing), we need to ensure that we are 'comparing apples with apples'.** Specifically, the terms of debt for developers at a corporate level has never been a topic under discussion in the Examination as it is an abstract question in the context of viability, requiring a broader understanding and context such that it is not applied misleadingly in answering the actual question at hand.

Master developers such as those quoted in the Homes England letter have a Gearing ratio (Debt / (Equity + Debt)) of around 25-35%, as the table below shows:

| | **Book Equity (£m)** | **Book Net Debt (£m) *** | ***Capital Structure % Equity*** | ***Capital Structure % Debt*** |
|---|---|---|---|---|
| **Canary Wharf Group** | 2,345 | 1,212 | *66%* | *34%* |
| **Urban and Civic** | 497 | 150 | *77%* | *23%* |
| **Quintain** | 785 | 451 | *64%* | *36%* |
| **Delancey** | *Not included due to business diversity* | | | |
| ***Average*** | | | ***69%*** | ***31%*** |

*Note: Figures taken from latest published annual filings*
** Where relevant includes creditors to reflect intercompany loans to subsidiaries*

This relatively low gearing ratio is credit-positive for the respective company and means that they can borrow at lower finance rates in line with those quoted in the Homes England letter. **But where they use this financing for projects, they need to generate a suitable return on their whole capital structure, not just the debt**, i.e. they need to take into account the cost of equity as well as the cost of debt.

If they fund the project with 100% debt, they need to generate the interest rate on that debt PLUS a suitably higher return (15%+ would generally be considered a suitable return on equity in this context) on around 3x that funding amount in equity (3x being driven by the 75:25 equity:debt ratio, i.e. 75/25 = 3).

**This is why Urban & Civic – a name quoted in EXD/079 and widely cited at the examination – on Alconbury and Rugby have a 20% IRR target**[1] - IRR here representing annual return on entire capital structure - **despite borrowing some of the funds at corporate level from Homes England at an apparently attractive rate**.

It is also not a surprise that a 12% IRR / Cost of Capital hurdle was noted as an appropriate and commonplace viability hurdle in a recent CBRE viability study for the Welbourne site[2], while Gerald Eve in their submissions comment (para 2.32 of Sep 2019 submission) that *"We consider that the target rate of return that we would expect to see on a private developer model would be circa 12-14% IRR on a present day basis"*.

We know from the Avison Young analysis for NEGC (Hyas IRR analysis is circularly meaningless as we explained at the EiP) **that plan-compliant IRRs at 300dpa are in the 3-6% range for WOBGC and CBBGC** (and would be materially lower if appropriate land acquisition and RTS costs were included).

**For the numbers to 'work' if developers were on-lending relatively low-cost Homes England loans for example, these figures would need to be over 12%** (a blended quarter debt and three-quarters equity capital structure, i.e. 25% * 5% + 75% * 15% = 12.5%); **in reality 12% is seen as a "standard" viability hurdle – these sites are more complex and high-risk and therefore one would expect developers to target higher returns** (indeed the larger Urban & Civic sites mentioned above provide supporting examples to this end)**.**

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[1] *Confirmed in an Urban & Civic equity research report by Jeffries, an investment bank (this can be provided to the Inspector if required).*

[2] "On strategic sites a key measure of viability is the IRR which should, ideally be, circa 12%+. The IRR reflects the profitability of a scheme over the investment period. For example a project may be viable but it may take several years for the profit to be realised. The IRR enables the impact of time to be explicitly taken into account."*, p25 in* https://moderngov.fareham.gov.uk/documents/s23065/Appendix%20B%20-%20Welborne%20Viability%20Review%20-%20Edited.pdf

**What this tells us is that private sector developers may be able technically to lend to a project from their balance sheet at artificially low rates vs the project's credit profile, but this would require strong returns from the project to provide the required return on equity, significantly in excess of what is evidenced here on a plan-compliant basis.** Indeed, this explains clearly why the private sector developer modelling has much lower infrastructure costs, in order to ensure that all-in returns are high enough to justify the project.

**Finally we note for completeness that the idea of a public-private partnership mentioned by NEGC Ltd simply combines or compounds the potential issues and complications expressed herein** – it neither mitigates State Aid issues nor provides any intrinsic improvement to required returns and therefore viability.

## Appendix A: Review of EXD/079 by Ed Charlesworth, Senior Credit Risk Professional

My name is Ed Charlesworth and I have been asked to comment upon specific aspects of the continuing Inspection in Public for the North Essex Authority Local Plans Part One.

By way of background, I am a finance professional with 23 years of experience in the banking and asset management industries. I have held senior lending and risk management positions in major European and US investment banks, and I am currently a Managing Director at one of the world's largest alternative asset managers, with funds under management in excess of $300bn. I currently act as the Credit Risk Officer for funds managed on behalf of several large insurance companies.

### Introduction

In its viability modelling, Hyas has assumed a real funding interest rate of 6%, with the project assumed to be 100% debt funded. In its Matter 7 response, NEGC supports the 6% rate and 100% debt structure, further stating that *"If the proposal is public sector led then our view is that a lower rate is likely to be achieved".*

**In my view, it is questionable whether the Garden Communities are financeable at all in the form and structure presented, but at the very least the rate assumed is woefully low considering the credit standing of NEGC (or a proxy thereof) at the point where it would seek to borrow up to £500 million. The lending proposition is highly speculative, and I do not believe that there is a commercial lending market which would be willing to lend to an unproven project where success or failure will not be clear for more than 20 years.**

Assuming, however, that a government entity would be willing and able to either lend to NEGC or provide credit support by way of a guarantee to a lender, it is important to determine that the assumed rate of interest would be compliant from a state-aid perspective.

### Creditworthiness

In order to determine the state-aid compliant rate of interest margin which a state body would be required to charge, it is first necessary to determine the creditworthiness of NEGC (or equivalent future entity) as a standalone entity. Homes England provided some guidance around this in the note appended to NEGC's Matter 5 response, referring to EU Guidance on the same topic.[3] The methodology provides a matrix against which i) creditworthiness (typically referred to as Probability of Default or "PD"); and ii) the level and quality of collateral are plotted in order to determine a margin (i.e. the interest rate charged in addition to the base rate; LIBOR in this case).

Table 1:

| Loan margins in basis points | | | |
|---|---|---|---|
| Rating category | Collateralisation | | |
| | High | Normal | Low |
| Strong (AAA-A) | 60 | 75 | 100 |
| Good (BBB) | 75 | 100 | 220 |
| Satisfactory (BB) | 100 | 220 | 400 |
| Weak (B) | 220 | 400 | 650 |
| Bad/Financial difficulties (CCC and below) | 400 | 650 | 1000 |

[3] EU Guidance is to be found at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1468318893850&uri=CELEX:52008XC0119(01)

Referencing the table, the Hyas interest rate might suggest a "Weak" level of creditworthiness with "Normal" Collateralisation or "Bad" creditworthiness with "High" to "Normal" Collateralisation (i.e. the shaded area above).

**It is important to note, however, that the credit analysis undertaken to determine the Rating Category assumes an existing business, with balance sheet and profitability history.**

The precedent transactions quoted by Homes England (Canary Wharf Group, Urban & Civic, Quintain & Delancey) are stated to have involved lending directly to existing master developers, who may then provide the capital to new project(s) which they are undertaking. The credit analysis undertaken by Homes England to determine an EU-compliant open-market rate would rely upon the existing balance sheet structure, track record and realisable assets of those companies, with only partial focus being on relative merits of any specific project(s). That is implicit in the EU Guidance, which lays out minimum margin rules for situations where loans are for *"borrowers that do not have a credit history or a rating based on a balance sheet approach, such as certain special-purpose companies or start-up companies"*

For example, Urban & Civic's credit ratios give it an implied rating of A+, placing it in the "Strong" Category on the table above.[4] The strong rating would underpin Homes England's assessment of a loan for that company.

**What would NEGC be Rated?**

The ratings assessment of a borrower or loan is based on a large number of factors, as well as the judgment and experience of the credit analyst. In order to attract a rating of BBB or better, ("Investment Grade" in Ratings Agency terminology), most or all of the factors would need to attract a "Strong" assessment). These factors are mentioned by Homes England and outlined in the table below, with NEGC assessed against each criteria:

Table 2:

| **Ratings Criteria** | **NEGC (or future GC entity)** | **Assessment** |
|---|---|---|
| | | |
| Historic track record, including trading history | No track record at all at time of borrowing | WEAK |
| A proven business plan which is likely to continue to be successful in the future | No proven business plan – success or failure only become clear after >15 years | WEAK |
| Sound balance sheet structure – prudent mix of equity (higher risk capital) and debt (lower risk capital) | 100% debt – no equity capital assumed whatsoever | WEAK |
| Strong coverage ratios – able to service a loan with significant headroom | Terrible coverage ratios for at least the first 15 years – no cashflow to service debt | WEAK |
| Meaningful financial flexibility – ability to withstand underperformance to plan whilst maintaining strong profitability metrics | Very little financial flexibility – projections are highly sensitive to changes in economic environment | WEAK |
| Strong liquidity – cash readily available to meet operational requirements as they fall due | No liquidity – all cash on Balance Sheet comes from borrowing for first 15 years | WEAK |

[4] *Source: Reuters Eikon January 2020*

Given that NEGC is assessed as "Weak" against every factor, it is highly unlikely in my opinion that the credit rating or PD for a newly-formed LLDC with no equity capital would be assessed by a credit professional as better than that of a "CCC"-rated entity[5]. For reference, of the 4,850 corporate issuer ratings maintained by Standard & Poors as of 31/12/2018, only 179, or 3.7%, were CCC+ or worse.[6]

According to Table 1, that suggests a margin in the range of 400bps to 1000bps.

**Collateralisation**

In order to determine where in the range of margins NEGC would fit, the value and quality of collateral needs to be assessed.

When looking at collateral, lenders will consider i) the quality of the asset they hold as security (prime real estate or agricultural land has a more stable value than, say, an poorly located industrial unit or the stock of a fashion retailer); ii) the ratio of Loan Amount to Collateral Value, otherwise known as Loan to Value or "LTV"; and iii) how readily the collateral could be realised (e.g. sold to a third party).

In the case of NEGC, the only asset available as collateral is the land bank, which for as long as it is owned by NEGC is either i) undeveloped agricultural land; or ii) land partially prepared for commercial development. This makes the land very difficult to sell to a third party, bearing in mind that the loan has most likely defaulted because NEGC has been unable to successfully develop it. There is an argument, therefore, that the land reverts to, at best, Agricultural Value at the point of a loan default.

**Other Collateral Considerations**

It may be argued by the NEAs or NEGC that it could raise debt against the infrastructure assets which it constructs within the GCs. That is patently not the case, as in order to raise finance against infrastructure, the underlying asset must be predicable, income-generating (in order to service the debt), and will tend to operate in a regulated industry. Infrastructure loans are raised *inter alia* by highly regulated businesses such as airports and utilities (e.g. water, electricity, gas companies); toll roads with long contractual concession periods; profitable energy infrastructure (e.g. transmission lines and gas pipelines); and telecommunications infrastructure (e.g. transmission towers).

In the case of NEGC, the infrastructure constructed will be in the form of i) schools and health facilities, which one would assume would not pay market rent; ii) transport infrastructure, which mostly requires subsidy in order to be profitable; and iii) community assets such as country parks and leisure facilities, which similarly tend to require Local Government subsidy. None of the infrastructure will be regulated in such a way that lenders could get comfortable with future income streams. It would therefore be disregarded by any commercial lender.

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*5 Definition of CCC – "An obligation rated 'CCC' is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation." Source: Standard & Poor's*

*6 Source: S&P Global Ratings Credit Ratings Performance Measurement Statistics*

**LTV**

Avison Young in their supporting analysis for NEGC provides details of Projected Borrowings for the three GCs and also land values at various points in the future. I am not a land valuation expert, so will take these numbers from appointed experts at face value.

The lowest ratio of LTV in Avison Young's spreadsheet (in 2033) is 991%. Given that i) a "strong" level for that ratio would most likely be anything up to 50%; and ii) anything over 100% implies that the collateral does not cover the loan, it cannot be said that the collateralisation of any loan to NEGC would fit anywhere but in the "low" column of the table.

**In fact, a 9% coverage of the loan by collateral would probably be seen by a commercial lender as entirely unsecured.**

**Assessment of Appropriate Interest Rate**

Based on the Homes England table, and the analysis above, my assessment is that the "market" rate of interest margin for a loan to NEGC would be **at least** 1,000bps, or 10%. Including the Base Rate, that suggests a Nominal Funding Rate today of 11%, or a real rate of 9%[7], 50% higher than the NEAs have modelled and around double the blended rate used by Avison Young for its modelling for NEGC.

**Conclusion**

The analysis laid out above makes very clear that the rate applied in the Hyas modelling is not compliant with state aid rules for government guarantees or loans.

Moreover, it is my view, based on my experience of bank and insurance company lending, that **no financial institution would be willing to take on the risk of NEGC with a 100% debt capital structure, even at the rate implied by the Homes England matrix. Lenders cannot be realistically compensated through a debt instrument for the level of speculation and delivery and risk in the project; put simply, it is equity risk.**

As well as the State Aid implications, this goes to the heart of the viability question for the NEAs, as the financial models are highly sensitive to Funding Rate.

**Ed Charlesworth**
**January 2020**

[7] Assuming 2% inflation