

Report Date: 12 January 2015

***Strictly Private & Confidential
Legally Privileged Information***

HEXAGON HOUSING ASSOCIATION LIMITED

Report on a proposed loan facility of up to £10,500,000 to Horniman Housing Association Limited

1 Introduction

- 1.1 You have agreed in principle to make a revolving loan facility in an amount of up to £10,500,000 (the **Facility**) available to Horniman Housing Association Limited (the **Borrower**) on the terms set out in a loan facility agreement (the **Facility Agreement**). The Borrower is a Registered Provider and your subsidiary.
- 1.2 A formal loan agreement is required and made available in order to record the terms of the transaction. This is important so that you can demonstrate that you will not breach the regulations of the Homes and Communities Agency, for tax and accounting purposes, for charity law compliance and to demonstrate that you and the Borrower have acted prudently.
- 1.3 The purpose of this brief report is:
 - 1.3.1 to set out the principal terms of the Facility Agreement;
 - 1.3.2 to comment on your ability as a charitable registered provider of social housing to provide the Facility;
 - 1.3.3 to confirm that the Facility Agreement is in substantially its final form; and
 - 1.3.4 to confirm that the legal terms of the Facility Agreement are “not inappropriate” for you to enter into.
- 1.4 This report is prepared for your board of management and senior management team and is subject to our terms of engagement. It should not be disclosed to, or relied upon by, any other person or made public without our prior written consent.
- 1.5 The scope of our instructions does not include advising on the accounting, tax and treasury implications of the Facility Agreement. Devonshires Solicitors have also acted for the Borrower in the preparation of the loan documentation.

2 Conclusion

- 2.1 You have the legal capacity to enter into the Facility if, having taken into account our advice below, you are satisfied that in doing so you will be advancing your charitable objectives and it is prudent for you to do so. Care should be taken to ensure that this is the case and that it can be demonstrated.
- 2.2 We would also recommend that you ensure you comply (and can demonstrate compliance) with the ongoing regulatory requirements of the Regulator; including through

appropriate stress testing). You should also take advice from your financial, tax and accounting advisers on the proposed transaction as this will be key to understanding whether the transaction is fully compliant. We understand from your officers that this is the case

2.3 We can confirm that the Facility Agreement is in substantially its final form and that the legal terms in the Facility Agreement are in a form that it would not be inappropriate for you to enter into. This confirmation is given on the assumption that:

2.3.1 the commercial terms of the Facility are approved by your board and the board of the Borrower; and

2.3.2 if consent is required from any of your funders to use loan facilities to on-lend to the Borrower, this consent has been obtained prior to completion of the Facility Agreement.

2.4 If you have any queries on the Facility Agreement please do not hesitate to contact Andrew Cowan (Direct tel: 020 7880 4350 or email: andrew.cowan@devonshires.co.uk).

3 Defined Terms

3.1 For the purposes of this report the following terms have the following meanings:

HCA means the Homes and Communities Agency.

HRA08 means the Housing and Regeneration Act 2008 as amended by the Localism Act 2011.

Registered Provider means a registered provider of social housing registered with the HCA.

Regulator means the Regulation Committee of the HCA.

Regulatory Framework means “The regulatory framework for social housing in England from April 2012” and the annexes to it issued by the HCA.

3.2 Unless otherwise defined in this report capitalised terms have the meaning given to them in the Facility Agreement.

4 The Facility

The Facility is a revolving credit facility of up to £10,500,000

5 Purpose

5.1 The Facility will be used by the Borrower for any purposes you agree, which accord with its rules and your investment policy.

5.2 Any drawdown notice needs to make clear the purpose of the Advance and which category the Advance would fit into.

6 Issues for consideration in relation to the Facility

6.1 Compliance with the Regulatory Framework

You will need to comply with the Regulatory Framework and, in particular, the “Governance and Financial Viability standard”. Under that standard a Registered Provider is required to manage its resources effectively to ensure its viability is maintained. Registered Providers are required to ensure that (i) effective controls and procedures are in place to ensure security of assets and proper use of funds, (ii) effective systems are in place to monitor and accurately report delivery of their plans and (iii) the risks of delivery of financial plans are identified and effectively managed.

Registered Providers are also required to ensure that they have a robust and prudent business planning and control framework to ensure there is access to sufficient liquidity at all times, financial forecasts are based on appropriate and reasonable assumptions and planning sufficiently considers the financial implications of risks to the delivery of plans.

You should ensure that you can demonstrate to the Regulator that you have in place effective mechanisms which ensure that you are and will be able to comply with the Regulator's standards and other regulatory requirements. This forms part of the new proposed regulatory requirements of the Regulator and therefore there is a lack of clarity about their exact requirements here. However, an understanding of the flow of risk around the group and how it is managed will be key. Your investment policy will be the starting point here.

6.2 Value for money (VFM)

The VFM standard emphasises the need for a comprehensive, strategic assessment of your approach to VFM in achieving its objectives. Again, the board should demonstrate that it has duly considered VFM implications of the transaction. The ones most relevant to investment include:

- 6.2.1 robust assessment of use of resources including “trade-offs” and “opportunity costs”;
- 6.2.2 an understanding of return on assets (measured against purposes and objectives);
- 6.2.3 a need for effective performance management and scrutiny functions; and
- 6.2.4 a requirement to demonstrate to stakeholders how you are achieving value for money, including annual robust self-assessment.

6.3 Tax issues

Whenever a charity makes a loan it must consider the “qualifying loan” rules. If the loan is not “qualifying” for tax purposes, our understanding from tax advisers is that the charity would lose exemption from corporation tax on an amount of income equal to the value of the non-qualifying loan.

There are a number of specific investments which are automatically considered a qualifying investment for tax purposes. However, a loan to a non-charity for non-charitable purposes is not covered by the specific list. If none of the specific categories

apply to a loan it must be made by the charity "for the benefit of the charity and not for the avoidance of tax" to be a qualifying investment for tax purposes.

The phrase "for the benefit of the charity" has been clarified by HM Revenue and Customs (HMRC) to mean one of two types of benefit:

6.3.1 direct charitable benefit as part of the charitable objects of the charity; or

6.3.2 commercial benefit as an investment of the charity's funds.

HMRC guidance on charitable benefits states that it is something which directly advances the charitable objects of the charity. We understand from your officers that compliance has already been confirmed by your tax advisers.

Where a loan or other investment will not fall within the charitable benefit test, the charity will need to consider whether the commercial benefit test can be met. HMRC will normally accept a loan is for the financial benefit of a charity where it:

6.3.3 carries a commercial rate of interest which is paid and actively pursued;

6.3.4 is adequately secured; and

6.3.5 is made under a formal written agreement which includes reasonable repayment terms.

In addition, there is a general Charities overall requirement for prudence in using the funds of a charity. So in our opinion, given the amount of the loan, this would mean the Board should still ensure that:

(a) you receive an appropriate return;

(b) the funds are only committed when you have them available and are returned to you when you require (which ties in with the "on demand" nature of the loan facility – which we comment on further in paragraph 11 below); and

(c) the transaction should be formally documented.

This rationale may need to be explained to the Regulator, to whom we would recommend you disclose the existence of this Facility given its size, although this is not a legal obligation but one of the Regulator's co-regulatory expectations.

6.4 **Charity Commission/vires issues**

In addition to the tax issues referred to above, your board must also have regard to the Charity Commission publication entitled "Charities and Investment Matters: a Guide for Trustees". This guidance has been produced to support board members of charities to make decisions confidently about investments that comply with their duties. Without being comprehensive, the guidance deals with the following:

6.4.1 the board has overall responsibility for investment and is primarily responsible for strategic decisions about how to use the charity's assets to achieve its aims. The board may delegate day to day decisions about investment to a third party i.e. an investment manager and/or to a specialist team within the organisation;

6.4.2 you need to consider whether investment in development is appropriate as a whole;

- 6.4.3 you need to consider and have regard to the need to diversify investments. As against this, you may take into account your particular expertise in areas of investment and areas where you are better placed to invest such as property over (for example) shares in companies engaged in businesses in relation to which you have less expertise;
- 6.4.4 your board should take advice from people experienced in investment matters where it considers it needs it;
- 6.4.5 you should review the investments and any investment manager from time to time and change them if necessary;
- 6.4.6 as a charity you should set investment objectives. We have worked with your officers and advisers on your investment policy. This sets out the key parameters you should consider from a charity perspective. This report has been provided on the assumption that you are confident you are complying with these parameters.
- 6.4.7 you should consider the level of risk that it is appropriate to accept, and identify that risk. The guidance identifies certain categories: capital risk; liquidity risk; market risk; valuation risk; counterparty risk; tax risk; and environmental, social and corporate governance risk;
- 6.4.8 the charity's powers of investment in relation to the nature and purpose of the investment. We have checked your rules and noted that rule B2.6 permits investments.

7 Development finance

- 7.1 We understand that the Facility will be used for development finance.
- 7.2 As a result the lending, security and financial covenants have been set to anticipate this form of use.
- 7.3 Because of the controls you hold on drawdown and repayment we have not been as specific as might otherwise have been the case about the full list of documentation that a funder might want for a committed loan facility.
- 7.4 Therefore, before permitting a drawdown you should ensure that you hold sufficient security and step in rights and are happy with the choice of consultants on the development in order that, in the event of a failure of the Borrower, you can step into the development you have funded and build it out in your own right.

8 Security arrangements

The Facility will be secured by a fixed charge over the development land (the **Fixed Charge**). You also reserve the right to require the Borrower to provide further security in the form of floating charges and the right to require contractors, sub-contractors and consultants to enter into guarantees or collateral warranties for protection during the development. The Fixed Charge includes covenants which are tailored to development finance.

9 Drawdown and availability

- 9.1 The Facility will be available for drawing for a period of four years from the date of completion of the Facility Agreement (the **Signing Date**). You may agree an extension of the availability period for two additional years if requested by the Borrower. It is in your

discretion whether to agree to an extension. We refer to the date on which the Facility will expire below as the **Final Repayment Date**.

9.2 The Facility can be drawn on a revolving basis during the availability period from the Signing Date and in minimum amounts of £1,000 (each an **Advance**).

9.3 The making of an Advance is subject to you having sufficient funds.

10 Conditions Precedent

Various documents will need to be delivered to you by the Borrower to complete the Facility Agreement. We will assist you in satisfying these requirements. These include:

10.1 the Fixed Charge executed by the Borrower;

10.2 a Business Plan acceptable to you; and

10.3 final agreed budget, project programme and development cashflow acceptable to you.

11 Interest Rate and Periods

11.1 The rate of interest will be 9% per annum. Interest is payable quarterly on the last business day of each three month interest period. If two or more interest periods end on the same date these will be consolidated into and treated as a single advance.

11.2 We would recommend that you take advice from your tax and accounting advisers on the impact and level of the interest rate.

11.3 Any amount that is overdue will bear default interest at 4% per annum over the interest rate applicable at that time.

12 Repayment, Prepayment and Cancellation

12.1 Repayment

12.1.1 The facility is repayable "on demand". This means it is immediately repayable at any time when you ask for repayment.

12.1.2 If no demand is made, each Advance is nevertheless repayable on the last day of the three month interest period to which it relates. Any amounts repaid will be able to be re-drawn unless an Event of Default has occurred and is continuing unremedied and unwaived. We describe these events below.

12.1.3 The Borrower will be deemed to make a new request for an Advance on the last day of each interest period (or such other period as agreed between the parties) unless it notifies you otherwise three business days before.

12.1.4 If no demand has already been made, the Facility will in any event be repayable in full on the Final Repayment Date (four years from the Signing Date) or following demand by you at any time.

12.2 Prepayment

12.2.1 The Borrower may prepay or cancel the whole or any part of an Advance on giving you not less than five business days' notice provided you are satisfied that the Borrower has sufficient funds to meet all of its obligations to other parties

following the prepayment. Any Advance which is repaid or prepaid may be redrawn during the availability period.

12.2.2 The Borrower will have to compensate you for any costs that you incur as a result of the prepayment.

12.2.3 You also have the right to charge breakage costs to compensate you for any losses, costs and/or expenses that you incur (directly or indirectly) as a result of a prepayment of any part of the Facility other than on the last day of an interest period.

12.2.4 In addition, if a related back to back arrangement is terminated early, the Borrower will be liable to reimburse you for any amounts you are obliged to pay to your counterparty as a result of the termination.

12.3 Cancellation

Your commitment to advance the Facility will be automatically cancelled on the Final Repayment Date. During the availability period the Borrower may cancel any undrawn amount on at least five days' notice provided that you are satisfied that the Borrower has sufficient funds to meet all of its obligations to other parties following the cancellation and that the Borrower compensates you for any costs you have incurred in making available the Facility (or the part that is being cancelled).

12.4 Illegality

If it becomes unlawful for you or any of your Funders to continue to make the Facility available any undrawn amounts of the Facility will be cancelled and you can require it to be repaid, together with accrued interest and any other amounts owing to you or a Funder, on the date specified by you.

13 Representations

Representations are statements of fact which must be true and correct on the date of the Facility Agreement and which are repeated by the Borrower on each drawdown date and the first day of each interest period. The representations are usual for an intra-group loan. They include:

13.1 *Status*: the Borrower is a non-charitable registered society and your subsidiary with power to enter into the Facility Agreement and exercise its rights and perform its obligations under the Facility Agreement and any Security Documents;

13.2 *Authorities and Validity*: all consents and actions required to authorise execution, delivery and performance of the Facility Agreement and any Security Documents have been taken by the Borrower;

13.3 *No filing*: it is not necessary that the Facility Agreement and any Security Documents be filed, recorded or enrolled with any court or other authority in England;

13.4 *Binding obligations*: the Borrower's obligations under the Facility Agreement and any Security Documents are legal, valid and binding and enforceable in accordance with their terms;

13.5 *Business Plan*: the Borrower is complying and will be able to continue to comply with the approved Business Plan that has been approved by you and has sufficient financial resources to meet the costs anticipated under the Business Plan.

14 Information requirements

The Borrower shall:

- 14.1 on request by you, provide information about its business, financial condition, operations, property assets and the progress of any development; and
- 14.2 not alter its financial year end without your prior consent.

15 Financial covenants

15.1 The Borrower must ensure that:

15.1.1 the aggregate of the outstanding Loan must not exceed the Development Costs outstanding from time to time; and

15.1.2 the undrawn amount of the Loan together with any amounts due to be paid but not yet received under any sales contract must be sufficient to cover all costs and expenses (including all interest and fees) which are not yet paid to achieve Practical Completion of the Development.

15.2 The definitions relating to these covenants are as follows:

15.2.1 **“Agreed Plans”** means the detailed architect’s drawings and specifications for the Development in form and content acceptable to and approved by or on behalf of the Lender (as may be updated or varied from time to time with the approval of the Lender);

15.2.2 **“Development”** means the construction of one or more properties on a single site or under a single development contract;

15.2.3 **“Development Costs”** means the costs incurred by the Borrower in carrying out the Development as tested against the monthly cost reports supplied by the Borrower to the Lender;

15.2.4 **“Practical Completion”** means practical completion of each Development in accordance with the Agreed Plans for that Development as certified to the Lender by the Borrower.

16 Undertakings

The Borrower gives various undertakings. These include:

16.1 *Negative pledge*: not to create security interests over any assets without your approval other than security interests created pursuant to a Security Document;

16.2 *Disposals*: not to dispose of all or any substantial part of its assets with a value in excess of £20,000 without your prior written consent other than:

16.2.1 the disposal of assets in accordance with the Business Plan; or

16.2.2 the grant of permitted encumbrances;

16.3 *Business*: to carry on its business in accordance with its constitution and to carry out its business and operate in accordance with the approved Business Plan;

- 16.4 *Business plan compliance:* not to incur any cost or expenses above £10,000 per annum outside the Business Plan;
- 16.5 *On-lending:* not to on-lend the Facility without your prior consent;
- 16.6 *Use of Advances:* not to use the Advances other than for a purpose which complies with paragraph 5 above;
- 16.7 *Professional team:* not to instruct any contractors or members of the professional team without your prior consent;
- 16.8 *Status:* save with your prior written consent (and if required by you, any Funder), to maintain its registration under the Co-operative and Community Benefit Societies Act 2014 and to maintain its status as your wholly owned subsidiary;
- 16.9 *Mergers and subsidiaries:* without your consent, not to commence proceedings to merge, amalgamate with or transfer any of its assets, business or undertaking to or receive a transfer of assets, business or undertaking from any other person or to have or create any subsidiary or enter into any joint venture;
- 16.10 *Insurances:* to maintain insurances on and in relation to its business and assets with reputable underwriters or insurance companies against such risks and to such extent as required by you and to ensure that the contractors and professional team have appropriate insurance arrangements as approved by you;
- 16.11 *Grant of Security:* to comply with any request by you to execute a floating charge over such assets as you may require; and
- 16.12 *Material contracts:* not enter into any contract which might reasonably be expected to have a Material Adverse Effect without your prior consent.

17 Events of Default

The Facility is repayable by the Borrower on demand by you at any time. Examples of events that form the parameters which, if breached, would mean that you would be most likely to take action have been included. It is within your absolute discretion whether to exercise your rights to demand repayment. These events are:

- 17.1 *Failure to pay:* the Borrower fails to pay any sum under the Facility Agreement when due;
- 17.2 *Breach of obligations:* the Borrower breaches any of its other obligations under the Facility Agreement and the default is not remedied within 14 days (or a longer period agreed with you);
- 17.3 *Misrepresentation:* any representation made by the Borrower in the Facility Agreement or in any related document, certificate or statement is materially incorrect or misleading in any material respect when made;
- 17.4 *Inability to pay debts:* the Borrower is unable or admits its inability to pay its debts as they fall due within the meaning of Section 123 Insolvency Act 1986, suspends making payments on any of its debts, commences negotiations with its creditors with a view to rescheduling any of its indebtedness, the value of the assets of the Borrower is less than its liabilities or a moratorium is declared in respect of any of its indebtedness;
- 17.5 *Winding Up:* unless frivolous or vexatious and discharged or withdrawn within one business day, any action, steps or proceedings are taken for the suspension of payments

by the Borrower, a moratorium of any indebtedness, winding-up, dissolution, administration or reorganisation of the Borrower, a composition, compromise, assignment or arrangement with any of its creditors, the appointment of a liquidator, receiver, administrative receiver, administrator, compulsory manager or other similar officer in respect of the Borrower or any of its assets or enforcement of any mortgage, charge, pledge, lien or other security interest securing any obligation of any person or any other agreement or arrangement having a similar effect over any assets of the Borrower;

- 17.6 *Execution or Distress*: any distress, execution or other process is enforced upon or sued out against any the whole or any part of the Borrower's undertaking or assets and is not discharged within 7 days;
- 17.7 *Cross default*: unless the indebtedness is under £50,000 in aggregate, any indebtedness owing by the Borrower is not paid when due or within any applicable grace period or any indebtedness is declared to be or otherwise becomes due and payable prior to its specified maturity as a result of default;
- 17.8 *Illegality*: it becomes unlawful for the Borrower to perform or comply with any or all of its obligations under the Facility Agreement or any of the obligations of the Borrower under the Facility Agreement are not or cease to be legal, valid and binding;
- 17.9 *Cessation of business or delays*: The Borrower ceases or threatens to cease any substantial part of its business or there is a delay to completion of any development;
- 17.10 *Environmental breach*. There is a breach of any environmental law or policy which you consider might have a material adverse effect on the Borrower;
- 17.11 *Repudiation*: the Borrower repudiates the Facility Agreement or shows intention to do so;
- 17.12 *Group-related defaults*: the Borrower ceases to be your subsidiary;
- 17.13 *Lender related defaults*: you are required to repay your obligations to any Funder except for scheduled payments of principal or interest or you believe that you would not be complying with charity law or the Regulatory Framework by permitting the Facility to remain in place; or
- 17.14 *Material Adverse Effect*: any event occurs which, in your opinion, might be expected to have a Material Adverse Effect.

A material consideration were you to want to take steps to recover any debts arising through the Courts would be that a statutory moratorium would be created automatically under the HRA08. This would involve the Regulator, as it has a statutory duty at that point to try and resolve the situation with the secured creditors.

18 Costs and general indemnity

- 18.1 The Borrower will pay your costs and expenses (including legal fees) for documenting the Facility Agreement and any Security Documents and in connection with the preservation and/or enforcement of your rights in respect of the Facility Agreement.
- 18.2 The Borrower is also required to indemnify you for (i) any cost, loss, expense (including legal fees) or liability which you may incur as a consequence of the occurrence of any Event of Default or (ii) any prepayment of any Advance prior to the relevant interest period or the Final Repayment Date or (iii) any loss you may suffer or incur which you believe is attributable to the Borrower.

19 Assignment

Neither party can assign or transfer its rights under the Facility Agreement except with the other's prior written consent.

20 Fees and Taxes

20.1 Arrangement Fee

The Borrower shall pay to you the arrangement fee of £5,000.

20.2 Tax

The Borrower shall pay all taxes that may be required in relation to the Facility Agreement.

This report is not intended to deal with all areas of the loan documentation but only those that we believe ought to be brought to your attention in connection with the legal structure of the transaction. This report is provided solely for your and your Board's use and may not be disclosed to or relied upon by any third party or made public in any way without our prior consent. This report is limited to the matters addressed in it.