Cabinet 26 February 2020	TOWER HAMLETS
Report of: Neville Murton – Corporate Director of Resources	**Classification:** UNRESTRICTED
Poplar Baths - Refinancing	

Lead Member	**Councillor Ronald, Cabinet Member for Resources and the Voluntary Sector**
Originating Officer(s)	Neville Murton – Corporate Director, Resources
Wards affected	Bethnal Green
Key Decision?	Yes
Forward Plan Notice Published	7 February 2020
Reason for Key Decision	Financial Threshold
Strategic Plan Priority / Outcome	**A borough that our residents are proud of and love to live in**

Executive Summary

The council entered into a long-term Public Private Partnership with Folera Limited in 2014 that delivered the restoration of leisure facilities at Poplar Baths, affordable housing and Haileybury community centre.

The senior financing debt arranged for the development period was due to mature in 2019, prompting a refinancing exercise to be carried out by Folera, and by extension the Council.

Recommendations:

The Mayor in Cabinet is recommended to:

1. Agree the arrangements for the refinancing of the Poplar Baths Scheme

2. Delegate to the Corporate Director, Resources in consultation with the Corporate Director, Governance, approval for changes to the project documentation to give effect to the refinancing proposal as set out in paragraph 3.41.

1 REASONS FOR THE DECISIONS

1.1 The council entered into a long-term Public Private Partnership with Folera

Limited in 2014 that delivered the restoration of leisure facilities at Poplar Baths, affordable housing and Haileybury community centre.

1.2 The senior financing debt arranged for the development period was due to mature in 2019, prompting a refinancing exercise to be carried out by Folera, and by extension the Council. The Council's approval of the refinancing is required, due to the Council's position as underwriter of elements of the project.

2 ALTERNATIVE OPTIONS

2.1 The Council has considered, and discounted, as part of the negotiations the option of itself providing the senior debt financing. However, the original agreement requires the refinancing to take place at this point in time.

2.2 There are other lenders in the market that could provide alternatives to the arrangement proposed however, the option currently proposed by Folera is understood to represent the most cost-effective solution and it is in all parties interest to secure the most advantageous terms for refinancing.

3 DETAILS OF THE REPORT

Background

3.1 In 2013, the council entered into a 30-year public-private partnership (PPP) transaction with Folera Limited (Folera). This was largely structured as a private finance initiative (PFI) project and delivered the restoration of leisure facilities at Poplar Baths, affordable housing and Haileybury community centre. Barclays Bank plc (Barclays) provided finance on a "project finance" basis meaning that, unlike many loan facilities, Barclays has extensive controls throughout the project structure.

3.2 The principal agreement by which the Council participates in the project is a development agreement originally dated 1 March 2013 and subsequently amended on 26 June 2014 (the Development Agreement). The development phase was completed in 2016 and since then Folera has been delivering the services since through subcontractors, including Guildmore Ltd (one of its shareholders) and Greenwich Leisure Ltd.

3.3 Whereas it is conventional in both PFI and non-PFI infrastructure projects for the senior debt to continue for the full duration of the project (i.e. until the point in time when the main contractor is required to hand assets back to the procuring authority, which in this project would be 2043) the senior debt in this project was entered into for a fixed period of 5 years. This is understood to be as a consequence of longer-term money not being available in commercial lending in 2013/14 and, as no new PFI projects were being closed at that time, fairly unique.

3.4 As a result, in addition to the conventional position where both the procuring authority and the developer have the right to trigger a refinancing of senior debt if they believe the market offers cheaper alternatives and enter into that arrangement by agreement, here there is additionally a point in time when refinancing must take place to avoid breaches of the finance documents with Barclays.

3.5 As the senior debt was originally due to mature and be repayable in full in mid-2019, Folera carried out a refinancing procurement exercise. As it was not possible to close the refinancing by then, the Council agreed to extend the period initially until 31 December 2019 and subsequently until 31 March 2020.

3.6 The standard form documents on which the Development Agreement is based (Standardisation of PFI Contracts, version 4) do not neatly deal with these circumstances and so it has been necessary to revisit and discuss certain parts of the structure.

3.7 Although the Council is entitled to a share in any refinancing savings, the Development Agreement provides that the project's Internal Rate of Return (IRR) must return to the level it was when the project was entered into in 2014. As Folera will also need to incur additional debt (described below), refinancing savings will technically not arise despite the margin for the senior debt being much lower now than it was in 2014.

3.8 The Council considered providing senior debt in place of Barclays and refinancing the project itself for a revenue benefit. Following due diligence, on 31 July 2019 the Mayor in Cabinet agreed to delegate the power to agree commercial terms on any Council lending to Folera to the Corporate Director of Resources.

Developments since July Mayor in Cabinet Approval

3.9 Following further discussions with legal representative, Folera and the various advisors, the decision was taken not to proceed with the Council being the lender due to both potential complications around negotiations and the low level of return the Council would have received due to very competitive bank quotes.

3.10 This decision was further supported by the rise in the PWLB rate margin to 1.8% over gilt yields in October 2019.

3.11 Folera has therefore proceeded with arranging refinancing with commercial banks.

Ongoing viability of the project

3.12 The Council will not be the lender, as explained later in this paper, however the Council "guarantees" all of Folera's debt in certain termination scenarios. Accordingly, the risk of debt repayment sits only in part with the refinancing institution. Although that institution is undertaking due diligence on Folera and the project as a whole prior to proceeding, this due diligence is understood to be relatively light-touch because it is taking significant comfort from the continuation of the "guarantee" of the senior debt from the Council.

3.13 Although our legal advisers have introduced changes to mitigate some of the Council's ongoing exposure, these are relatively modest in overall terms and it is noted that certain parts of the Development Agreement as originally drafted and agreed in 2014 and which will continue after the refinancing, are more lender-friendly and averse to the Council than is typical in PFI. For this reason, it is important that the Council continues to be satisfied that Folera's business is sustainable given the consequences to the Council if it encounters difficulty in the future.

Details of Arrangement

3.14 Folera sub-contracts the leisure and facilities management services to Guildmore Ltd. The performance of the contracts is subject to a guarantee by Guildmore's parent, Excel Portfolios Ltd. Guildmore Ltd subcontracts the leisure contract in full to Greenwich Leisure Limited. The project was costed to produce a return to the shareholders of Folera of 8.5% (internal rate of return, IRR).

3.15 The Council pays a unitary charge to Folera to run the services. The project is performing, but reports seen by the Council indicate that the operating performance of the leisure facility has been disappointing (The Sports Consultancy report, 11 April 2019).

3.16 Folera's senior debt is currently around £33m, owed to Barclays and repaid throughout the life of the loan until maturity in 2043. The project/ Folera required further injections of capital from the parent company(s) due to issues during construction and cladding replacement works. The injection took the form of additional debt, although subordinated to the senior bank debt. Subordinated debt currently totals approximately £15m.

3.17 Folera also has an interest rate swap to hedge the floating rate of the senior debt, changing it to a fixed rate. Due to the substantial differential between the swap rate and current market rates, the swap is valued heavily in the bank's favour; the break cost is estimated at £12m. The swap contains a mandatory break in December 2019 (since extended to March 2020).

3.18 The Council effectively underwrites or "guarantees" part of the arrangement under the Development Agreement. The Development Agreement splits the arrangement for the purposes of default resolution into two parts; the Leisure Tranche and Non-Leisure Tranche. The Leisure Tranche is essentially guaranteed by the Council. Should the leisure element of the arrangement default, the Council could be liable to pay the net amount of bank lending, hedge break costs (which changes with the market value of the swap) and any additional amounts to Folera, which Folera will then use to redeem the Leisure Tranche debt. On this event, the Council can choose to take ownership of the Poplar Baths leisure centre.

3.19 The Non-Leisure Tranche presents somewhat less risk to the Council. Unless caused by the Council, a failure of Folera due to this will prompt a resolution process leading to the market value of the project being taken into account as part of the payment by the Council and the return of the assets. The bank therefore bears the risk that the payment is less than the debt.

3.20 Should the Council be liable to cover the Leisure Tranche due to a leisure default, the payment is estimated at £20m, though the precise figure will depend on factors at the time.

3.21 The details of the Folera arrangement and company structure, and the financing are also fully referenced in the Cabinet report dated 31 July 2019.

3.22 It is important to recognise that although the Leisure and Non-Leisure components have different “guarantee” structures, Folera is a single business operating through a single special purpose vehicle. To illustrate this in practice:

- there is a single set of controls in favour of the provider of senior debt. If one of the businesses starts to fail, this may trigger wider breaches or defaults even if the other business is performing well; and
- there is a single set of documents (rather than a set for Leisure and another set for Non-Leisure) and so if one of those businesses is to end, the parties may need to negotiate the removal of that business from the contractual structure.

Refinancing

3.23 Folera has approximately £33m of senior debt outstanding from Barclays, which is due to be refinanced in March 2020. The financing arrangement also includes interest rate hedges in the form of swaps, which mandatorily terminate in December 2019, though deferral has been agreed to retain this until March 2020. The break cost for the interest rate swap has been estimated at around £12m. This has been verified by both the Council’s and Folera’s advisers, but the actual value will depend on market levels at the time the swap is broken. It is anticipated that the Council will participate in the swap termination call and will be asked to agree to the final swap break figure as a condition to the refinancing proceeding.

3.24 The Council’s approval of the refinancing is required, due to the Council’s position as underwriter of elements of the project. The Council is required to agree:

- the amount of new debt;
- the split between the leisure and non-leisure tranches;
- the eventual agreement terms.

3.25 The Council’s objective in this process is to limit both the risk of Folera failing and the size of the Council’s exposure should Folera fail within the parameters of what is achievable on a refinancing of this type and the terms of the existing documents.

Consequences of Refinancing

Amount of New Debt

3.26 Throughout 2019, Folera has sought Council agreement for various refinancing options, most of which included the prospect of borrowing more than necessary (up to £11m) to release equity/ pay back subordinated debt to the shareholders. The Council has pushed for a limit on the amount of new debt, using its “veto” to resist additional debt for equity release. The cost of servicing additional debt may have been bearable for Folera, but will make the company more sensitive to any changes in other costs and income, which may have increased the chance of failure. Such increases are also not thought to be in line with market norms in PFI refinancing generally.

3.27 The Council has maintained that Folera should only borrow enough to refinance the current debt, break the current swap, pay both related fees and a tax payment to HMRC (due to company restructuring). The swap break is costly, but achieves:

- an overall cost of debt for Folera that leaves the company in a more sustainable position and therefore reduces the prospect of Council involvement;
- the ability to refinance the project for the reminder of its life with another bank, rather than just 10 years with the current lender, Barclays.

3.28 Breaking the swap can be avoided by allowing the current swap to be bought by (novated to) another bank. Unfortunately, the cost of this for the new lender would have added to Folera's debt costs and its terms would in any event not necessarily be optimal for the new debt with the proposed institution. The decision was therefore taken to allow Folera to borrow the necessary amount to repay the swap.

3.29 While the amount of the debt will increase, the potential liability faced by the Council in the absence of other issues should stay broadly similar. As noted above, the potential liability is the bank lending plus hedge break costs. After refinancing, the swap will have a minimal value, whereas the debt will be larger, but the overall payment for the Leisure Tranche will be very similar to that estimated above (£20m).

3.30 Fees for lenders and professional advice on the refinancing, both for Folera, the lender and the Council, will be added to the borrowing required. This is estimated at around £1m. The Council has agreed with this additional borrowing. This is understood to be consistent with market practice in PFI refinancing more generally.

3.31 The tax charge relates to Folera's accounting treatment of the business and the way in which HMRC could categorise the company. This could lead to future complications, so the company has restructured to mitigate these risks, but this will prompt an upfront tax charge. The Council is keen to see the risks to the company mitigated to reduce the likelihood of financial involvement, so has agreed that Folera can borrow this additional amount (estimated at £1.5m).

Split between Leisure and Non-Leisure Tranches

3.32 The debt is currently split between the Leisure and Non-Leisure Tranches in a 45:55 ratio. This split is understood to have been calculated in 2013/4 on the basis of the relative level of capital expenditure and therefore the relative level of senior debt required. There is sound logic in this: in a scenario where there is a termination of one of these parts, the compensation payable by the Authority should naturally be sized to repay the debt which was required to develop that part of the structure.

3.33 Folera maintains that this approach was incorrect notwithstanding that it would have received scrutiny by the separate financial advisers for the Council, Folera and Barclays. Folera also say that the proposed institution will require this to be based on the Council's unitary charge payments, as these contribute to Folera's income that repays the debt (therefore in part determining the likelihood that the debt continues to be repaid), rather than build costs. The unitary charge is split 53%:47%.

3.34 It is noted that Folera are unwilling to ascertain whether commercial lenders in the market other than the proposed lending institution would take this same position.

3.35 While recognising the commercial necessities of refinancing, the Council does not want to increase its potential liability in the event of a leisure default and has therefore pushed back on this point.

3.36 In conjunction with the new lender, Folera carried out modelling to calculate the impact of a leisure default on the business model and so the necessary size of non-leisure debt that the business could support in the event that the leisure unitary charge was no longer forthcoming. Following this modelling, the lender agreed a debt split of 50%:50%. The split is necessary to ensure that the Council's unitary payments to Folera are enough to cover the cost of providing the non-leisure services should the leisure aspect of the contract be terminated.

Other Issues and Risk Mitigations

3.37 The Council and Folera have agreement to split the benefit of the value of the interest rate swap equally, where this is in excess of the outstanding debt in a termination situation. The chance of this outcome is low, but the Council will receive an additional benefit should this occur. Additional details are set out below.

3.38 The Council has negotiated a position in which it has control over the swap break in a termination situation, thereby being able to enforce the break to potentially offset the cost of the repaid debt. If interest rates rise, the swap will increase in value for the borrower (Folera), reducing the level of the repayment necessary to pay back the bank. Ensuring that the Council has control of this process, reduces the risk of the debt requiring repayment without the offsetting benefit of the swap break cost and maintains a similar level of the Council's potential liability as that prior to refinancing. This is described in more detail below.

Agreement terms

3.39 It is proposed that the Council enters into a deed of variation to change and supplement certain key terms in the Development Agreement. In addition, the Council will enter into a new direct agreement with Folera and the proposed lender as is conventional on a refinancing.

3.40 Folera originally proposed a number of minor changes to the Development Agreement to give them more flexibility and a reduced requirement to obtain consent from the Council in certain circumstances. These were successfully resisted and so are not summarised below.

3.41 Key components of these new documents include the following:

- Amendments to accommodate a new set of Finance Documents with the proposed lender, which include:

- a new facilities agreement;
- a new intercreditor deed, regulating the priority of the new senior debt from the proposed lender and the existing junior/shareholder from Folera's owners;
- a new accounts agreement; and
- new security documents to be created by Folera and its parent in favour of the proposed lender;
- new direct agreements between Folera, the proposed lender and each other counterparty to the documents involved in the wider structure.

- Amendments to all of the underlying Project Documents, either requested by the proposed new lender, or Folera or one of the other project parties.
- Drafts of early versions of some of these have been provided to our advisers and accordingly all remain subject to review. However, the expectation is that they largely follow the terms of the existing financing with Barclays. To the extent material differences become apparent, these will be relayed to the Corporate Director of Resources for consideration and a delegation to that effect is proposed.
- New certificates to be given by the Council under the Local Government (Contracts) Act 1997 to the proposed new lender.

  Drafts of these have not yet been provided to our advisers and accordingly remain subject to review. However, the expectation is that they largely follow the terms of the existing financing with Barclays. To the extent material differences become apparent, these will be relayed to the Corporate Director of Resources for consideration and a delegation to that effect is proposed.
- Removal of the legal structure for the grant of leases, as it is understood that that the leases were in error never procured by Folera. In their place, a licence structure on comparable terms has been introduced. Our legal advisers have considered the documents from a finance rather than property law perspective and are not familiar with the particular requirements insofar as property matters are concerned. However, they have compared their terms to wording seen in other PFI transactions and note that it is similar.
- Confirmation that Folera will not transfer to itself or its shareholders as a "windfall gain" at the point of refinancing amounts standing to the credit of a "debt service reserve account" with Barclays and will instead use that balance for the benefit of the project. The Council should be aware that it will be "guaranteeing" a new loan facility from the proposed lender to enable Folera to manage liquidity, which is different from the financial structure with Barclays where money was set aside and therefore not guaranteed. Such a feature is occasionally seen in project finance and accordingly not seen as a feature which the Council can insist operates differently here. However, we will need to ensure the size of the new loan facility; our advisers say that this should be limited to finance costs over the subsequent six months.
- The ability of the Council to verify the new financial model before it goes live and for any updates at the point of refinancing to track an agreed financial

close protocol, thereby limiting the Council's exposure to changes which it has not seen and agreed.

- The Council's participation in the protocol to enter into the new hedging transactions with the proposed lender which form part of the finance structure.
- It is proposed that the Council has a new right in limited future circumstances to compel Folera to break the new hedging transactions entered into with the proposed lender. The background to this component is as follows:

  - As discussed above under the heading "Amount of new debt", one of the consequences of proceeding with the refinancing in the current low interest-rate environment is that there is a significant cost in breaking the current hedging transactions which were entered into in 2013 (the **Old Swap Cost**). Additional debt will be borrowed from the proposed lender to pay for this, and the Council will "guarantee" that debt.
  - When the refinancing with the proposed lender goes live, a new swap transaction will be entered into based on current interest rates. Accordingly, if interest rates increase in the future, Folera will be entitled to receive a gain from the proposed lender (the **New Swap Gain**) if the swap can be terminated.
  - If interest rates return to the level they were in in 2013, the amount of the Old Swap Cost and New Swap Gain could be similar.
  - If part or all of the project is terminated, the Council will be required to pay a termination sum to the proposed lender. This sum will include the new debt used to pay the Old Swap Cost but importantly will be lower if there is a New Swap Gain. However, the finance documents include a standard mechanism to prevent the swap being terminated and a New Swap Gain arising in circumstances where Folera is insolvent. Our advisers have therefore sought to include a new mechanism to avoid this, so as to protect the Council as far as possible.
  - Our advisers initially proposed that a recognised hedging adviser determines a notional swap break figure where it is not broken at the appropriate time. The proposed lender rejected this on the basis that Folera will be able to break the swap in all circumstances – and so our advisers are seeking to include enhanced rights for the Council to ensure this really is the case. At the time of writing, the detail of these enhanced rights has not been settled.

- To help mitigate some of the risk which the Council is assuming by proceeding with the refinancing, it has been agreed than in circumstances where, on a termination, the New Swap Gain is higher than the amount of debt owed to the Lenders, the Council will be able to enjoy half of that upside. The detail is yet to be settled and it may be that this upside will need to be treated as any other receipt by Folera, meaning that part of it may need to be applied towards other costs first. However, provided that the part of this which would otherwise flow to Folera is shared with the Council, the arrangement is thought to be acceptable.

4 EQUALITIES IMPLICATIONS

4.1 There are no equalities implications from the propose refinancing**.**

5 OTHER STATUTORY IMPLICATIONS

5.1 This section of the report is used to highlight further specific statutory implications that are either not covered in the main body of the report or are required to be highlighted to ensure decision makers give them proper consideration. Examples of other implications may be:

- Best Value Implications,
- Consultations,
- Environmental (including air quality),
- Risk Management,
- Crime Reduction,
- Safeguarding.
- Data Protection / Privacy Impact Assessment.

5.2 The negotiations are primarily concerned with protecting the Council's position in the context of the existing position on the project and the associated documentation. In particular the Council has sought to maintain a broadly similar position in relation to risk transference; this has largely been achieved. Professional specialist legal and financial advice has been procured from Eversheds Sutherland and Arlingclose respectively and this has been used to mitigate any issues.

5.3 Folera has explored a number of market options to determine the best value refinancing package which is to the benefit of themselves and the Council.

6 COMMENTS OF THE CHIEF FINANCE OFFICER

6.1 This report is primarily financial in nature and the financial implications have been included throughout the body of the report. The CFO has nothing additional to add.

7 COMMENTS OF LEGAL SERVICES

7.1 The Council has the legal power to enter into this refinancing arrangement

7.2 The Council services the payment of the financing by paying to Folera the regular unitary charge for use of the buildings under the development agreement. However, as detailed in the report the Council guarantees the payment of the debt repayments in the event that Folera fails or some such other circumstance causes the development agreement to end. However, this should not be seen as an unusually high risk as the development agreement also provides that the buildings would become the property of the Council in the event that the Council is required to pay the debt directly.

7.3 In the event that the Council did not have the funds to satisfy the debt, the Council has the legal power to borrow the funds from the market in a manner considered under the alternative options. This would be an option which whilst not as attractive as the recommended option is no less feasible and considered standard practice.

7.4 There are no immediate legal implications arising under the Equality Act 2010 arising from this report

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Linked Reports, Appendices and Background Documents

Linked Report

- Cabinet report 31st July 2019 Poplar Baths – Refinancing (EXEMPT)

Appendices

- NONE

Background Documents – Local Authorities (Executive Arrangements)(Access to Information)(England) Regulations 2012

- NONE.

Officer contact details for documents:

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