Herefordshire Council

Financial Assurance Report – Keepmoat Homes Limited

November 2017

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1. Executive Summary

Keepmoat Homes Limited (KHL) has been selected as preferred bidder by Herefordshire Council (the Council). The intention is to contract with KHL as the Council's Development and Regeneration Partner. Contractual arrangements are anticipated to be for an initial period of 10 years, with the option to extend the partnership for a further 10 years. The maximum programme/contract value over the potential 20-year period is £200m. Projects would be undertaken on an individual basis.

The Council appointed JL Advisory LLP (JLA) to undertake a financial assurance review of Keepmoat Homes in accordance with the Specification set out in the 'Invitation to Quote for the provision of Financial Assurance in respect of the appointment of a Development and Regeneration Partner', issued by the Council on 19th October 2017.

In response to the Specification, this report considers the financial position of KHL and, where deemed relevant, that of its group companies. The latest available accounts for all entities are made up to 31 March 2017.

The report is set out in the following sections to cover the requirements of the Specification:

- Group Structure – provides an overview of the Keepmoat group structure and interdependencies;
- Analysis of Financial Records - reviews the KHL and Keepmoat Limited accounts and comments on financial performance; and
- Analysis of Financial Standing – considers ratio calculations and assessment in relation to the proposed contract appointment.

The review is based on historic financial information, which will not necessarily predict future results. To highlight as far as possible any factors that might have impacted the financial position of the Keepmoat group after the publication of the 2017 accounts, press searches have been completed and Dun & Bradstreet reports obtained. Information from these sources is included where relevant.

1.1 Key Points

The completed analysis highlights the following points:

- On 30 April 2017, the Keepmoat group sold the Regeneration segment of its business (Keepmoat Regeneration Holdings Limited) for a gross consideration of £330m. The Regeneration segment represented 62% by turnover of the total Keepmoat Limited business. The continuing operation is primarily KHL, described in the accounts as *'a partnership house builder focused on brownfield opportunities in areas benefitting from housing-led urban regeneration'*. We assume that this change in group structure in terms of technical capability to act as the Council's Development and Regeneration Partner has been considered in the evaluations completed to date.
- The sale proceeds of £330m were used to reduce the debt of the group and to pay dividends to the ultimate shareholders of the group. The remaining senior secured notes of £100m are due for redemption on or before 15 October 2019. This reduction in debt has reduced the gearing of the wider Keepmoat group and has allowed it to maintain its positive credit ratings.
- The quick ratio for both KHL and Keepmoat Limited is below 1, which could give concerns as to their liquidity. However, this is not untypical for companies within the house building industry as significant assets are tied up in land and work in progress. The quick ratio for Keepmoat Limited in particular, the entity which is providing the Parent Company Guarantee,

is close to the average quick ratio returned from the analysis of a sample of competitor accounts.

- Keepmoat Limited set up a new joint venture, ilke Homes, with Elliott Group in May 2017. This is a venture to provide modular offsite-constructed homes. As this is a new venture, the financial investment, risks and forecast returns are not publicly available.
- Dun & Bradstreet scores for both Keepmoat Limited and KHL are positive, giving a key risk score of 5A 1 for both companies.
- The 22 November 2017 Budget announcements relating to house building are likely to have a positive impact on activity in the sector. In addition, given the focus on affordable housing and first-time buyers, KHL should be well placed to take advantage of this.

1.2 Risk Areas and Recommendations for Mitigating Risks

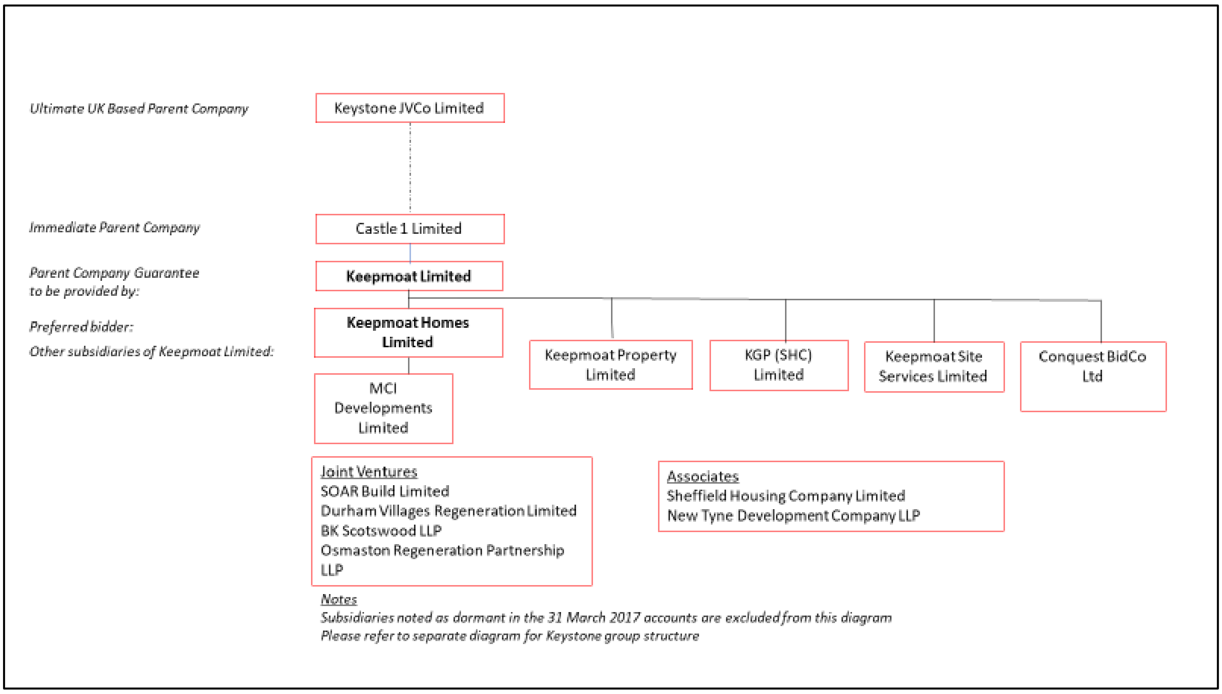
Risk Area	Recommendation for Mitigating Risks
The Regeneration segment of the Keepmoat business was sold on 30 April 2017. The remaining business is predominantly house building, which may not fit as well with the Council's requirements for a Development and Regeneration Partner.	The Council should ensure that it is satisfied itself that this change to group structure does not impact KHL's technical ability to be the Council's Development and Regeneration Partner.
The Keepmoat group has £100m of senior secured notes due for redemption on or before 15 October 2019. There is a risk that the group will be unable to refinance or repay the loan notes out of cash reserves.	It is common practice for housebuilder and developers to refinance their loan facilities on a regular basis, so the risk that the Keepmoat group cannot refinance in 2019 is believed to be low. The risk is further mitigated by the repayment of most of the debt following the disposal of the Regeneration division, therefore no action is recommended at the current time.

1.3 Summary

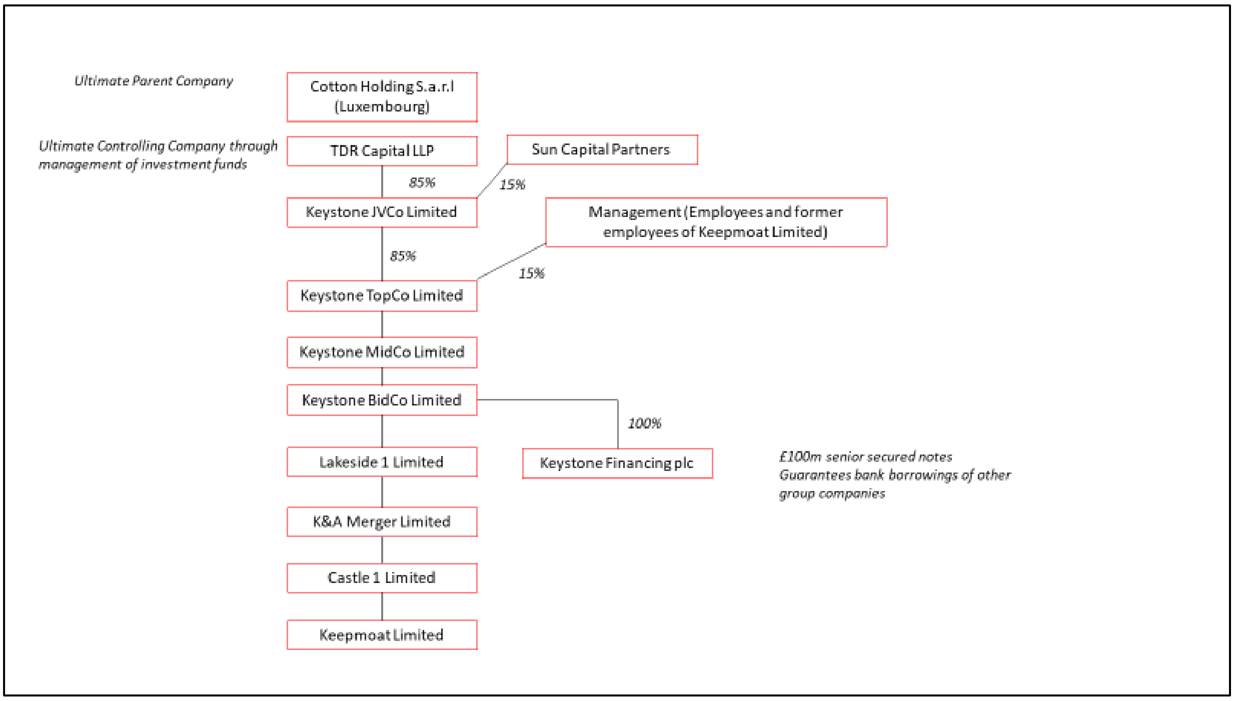
Although the points above should be noted, our review in accordance with the Specification has not identified any significant financial risks which would impact on the preferred bidder's financial capability to undertake the Development and Regeneration Programme with the Council.

2. Group structure and organisational interdependencies

The preferred bidder is KHL with the Parent Company Guarantee provided by Keepmoat Limited. The simplified group structure for Keepmoat derived from the 31 March 2017 statutory accounts is as follows:



Financing for the Keepmoat group originates from several other group companies. The following diagram shows the structure of the holding and financing companies.



2.1 Acquisitions, Disposals and Recent Investments

Keepmoat Regeneration

On 1 March 2017, the Keepmoat group entered into a sale agreement to dispose of the Regeneration segment of the business to ENGIE. The sale of Keepmoat Regeneration Holdings Limited and all related subsidiaries took place on 30 April 2017 for a gross consideration of £330m.

The accounts for Keepmoat Limited treat the results from the regeneration division as a discontinued operation and therefore trading figures stated within this report relate to the continuing operations only.

MCI Developments

On 10 January 2017 Keepmoat Limited group acquired MCI Developments Limited, a provider of packaged developments and social housing in North West England. Initial consideration of £12.61m was paid with the balance of £8.142m being deferred as contingent consideration based on the future performance of the business. MCI Developments is a 100% owned subsidiary of KHL.

Ilke Homes

In May 2017 Keepmoat Limited entered into a joint venture, ilke Homes Limited, with Elliott Group, an offsite specialist. Ilke Homes will invest in modular offsite construction of homes. Ilke Homes Limited was incorporated on 10 August 2017 and its ultimate holding company is ACJ Holdings registered in Jersey.

2.2 Financing

Keystone Financing plc holds senior secured notes which were issued in relation to the refinancing of Lakeside 1 Limited. At 31 March 2017, these had a principal value of £263m, bearing interest at 9.5%.

On 15 June 2017, following the disposal of the Regeneration division, £163m was redeemed, incurring an early repayment charge of £7.7m (total cost of redemption was therefore £170.7m). Following this repayment, senior secured notes with a principal value of £100m remain. The redemption date for the remaining balance is on or before 15 October 2019. Typically, companies will undertake a refinancing to redeem the notes on or before the redemption date.

In addition to the part redemption of the senior secured notes noted above, Keepmoat Limited used the proceeds from the sale of the regeneration business and an addition £35m capitalised from the unrealised profits of the company as follows:

- Paid an interim dividend of £145m to Castle 1 Limited on 12 May 2017. This flows up through the holding companies to repay preference shares of £119.1m (which attracted a coupon of 12% per annum) held in Keystone TopCo and to pay dividends of £25.9m to the ordinary shareholders of Keystone TopCo Limited.
- Paid a further interim dividend of £25.4m satisfied in specie by transfer to Castle 1 Limited of a receivable from Keystone TopCo Limited.

Keystone Midco Limited has a revolving credit facility with a maximum facility of £75m and an overdraft of up to £20m available for use by Group companies. This is due for renewal at 31 March 2019. At 31 March 2017, the Group had bank borrowings under the facility of £5m and an overdraft of £20.5m. The Keepmoat Limited group guarantees the revolving credit facility in the form of a fixed charge over certain freehold land and buildings and floating charges over the assets of certain group companies. The undrawn facility at 31 March 2017 is £49.5m, which can be made available to group companies if required.

At 31 March 2017, KHL had a £5.9m Builders Finance Fund loan from the Homes and Communities Agency (HCA). The Builders Finance Fund was designed to help restart and speed up viable housing developments that had slowed down or stalled. Interest is charged at the European Central Bank Rate plus a margin (4.5% to 6.5% depending on the site). The amounts are repayable on completion of each site to which the loan relates.

2.3 Summary

The sale of the Regeneration division post year end is a significant transaction in the context of the overall size of the Keepmoat group. However, from a financial perspective it has allowed the Keepmoat group to repay a significant proportion of its debt liabilities. This reduces the ongoing interest and repayment obligations the group must meet, and therefore reduces the overall financial risk of the group.

3. Financial Records

All statutory accounts reviewed have been prepared on the going concern basis. This means that the Directors are satisfied that the group and relevant company have adequate resources to continue in operation for the foreseeable future, being at least 12 months from the date of signing the financial statements (14 July 2017).

In preparing this report, we have reviewed accounts for KHL, as preferred bidder, and Keepmoat Limited, as the entity providing the Parent Company Guarantee.

3.1 Keepmoat Homes Limited commentary for 2017

Year ended 31 March	2017		2016		2015
	£m	***Change from PY***	**£m**	***Change from PY***	**£m**
Profit and Loss					
Revenue	413	*23%*	337	*28%*	262
Operating profit (after exceptional items)	38	*60%*	23	*10%*	21
Profit for the financial year	**29**	***52%***	**19**	***-8%***	**20**
Balance Sheet					
Total Assets	371	*41%*	263	*16%*	226
Total Liabilities	280	*40%*	200	*13%*	177
Equity	**91**	***46%***	**63**	***28%***	**49**

Profit and loss

KHL revenue for the year ended 31 March 2017 was £413m, a 23% increase from the previous year of £337m. The increase is due to a higher number of plots being sold, a higher selling price per plot and the acquisition of MCI Developments. The Strategic Report within the accounts refers to the growth being supported by their regional expansion programme.

The growth in 2017 builds on the growth reported in 2016, which was 28%, which suggests strong performance by KHL in recent years.

Profit for 2017 is 52% higher at £29m compared to the profit for 2016 of £19m. The percentage increases in cost of sales (20%), and administrative expenses (13%) are less than the 23% increase in revenue, giving an increase in operating profit.

In 2016, KHL sold its entire shared equity debtor book, generating a loss on disposal of £3.2m, which at least in part explains the drop in operating profit margin in that year.

Finance costs are higher in 2017 at £2.5m compared to £1m in 2016. This represents the unwind of discounts on deferred land payments.

Balance sheet

Key movements on the balance sheet between 2017 and 2016 include:

- additions to fixed assets of £0.5m;
- an increase in land held for and under development from £94m to £144m;
- an increase in house building work in progress from £103m to £149m;
- an increase in development land payables from £58m to £96m; and
- an increase in other loans representing the Builders Finance Fund of £6m.

These increases are consistent with a growing business, which is experiencing increased market activity.

KHL has contingent liabilities of £10m relating to amounts outstanding under performance guarantees in the normal course of business.

3.2 Keepmoat Limited commentary for 2017

Year ended 31 March	**2017**		**2016**		**2015**
	£m	***Change from PY***	**£m**	***Change from PY***	**£m**
Profit and Loss					
Revenue	423	*26%*	337	*-69%*	1,095
Operating profit	28	*12%*	25	*-55%*	56
Profit for the financial year (continuing operations)	**17**	***-35%***	**26**	***-41%***	**44**
Balance Sheet					
Total Assets	500	*-29%*	701	*4%*	671
Total Liabilities	298	*-35%*	484	*25%*	388
Equity	**202**	**-7%**	**216**	**-23%**	**283**

The Regeneration segment of the business was sold on 30 April 2017, therefore both the current year and 2016 comparative figures for profit and loss exclude this segment. The balance sheet figures for 2017 exclude the regeneration business and the 2016 figures include it. The 2015 figures for both profit and loss and balance sheet include the Regeneration business.

Profit and loss

The Keepmoat Limited group revenue from continued operations for 2017 was £423m, a 26% increase from the previous year of £337m. Following the disposal of the Regeneration business, KHL is the main trading company within the Keepmoat Limited group, hence the increase is again explained by a higher number of plots being sold, a higher selling price per plot and the acquisition of MCI Developments.

Operating profit of £28m in 2017 is only 12% higher than the comparative from 2016. Administrative expenses are higher at £42.2m in 2017 compared to £26.8m in 2016 and these include £5.7m costs associated with the disposal of the regeneration business, which are therefore non-recurring, and £1.9m amortisation of intangible assets.

Profit for the 2017 financial year from continuing operations at £17m is 35% lower than for 2016. This is explained by the unwind of discounts on deferred land payments in Keepmoat Homes and a tax charge of £8.5m compared to a tax credit of £1m in 2016.

Balance sheet

Assets and liabilities have reduced due to the disposal of the regeneration business. Other significant changes to note are:

A reduction of £111m in goodwill and other intangible assets, explained by:

- Reclassification of goodwill within the Regeneration business of £122m to assets held for disposal.
- Addition of £6.3m goodwill and £6.4m contracted customer relationships from the acquisition of MCI Developments.

An increase of £96m in inventories from £197m to £293m from KHL:

- an increase in land held for and under development of £50m
- an increase in house building developments in progress of £46m.

An increase in the provision for liabilities from £2.1m in 2016 to £8.6m in 2017. This reflects:

- The contingent consideration of £8.1m on the acquisition of MCI Developments
- Reclassification of £1.1m of provisions for liabilities relating to the disposal of Regeneration.

3.3 Summary

KHL accounts show a company that has reported steady growth over the last three years. Profits and net assets have increased over the period and our review of the company accounts has not raised any particular areas of concern. The Keepmoat Limited accounts are more difficult to analyse due to the disposal of the Regeneration division and the restatement of the accounts to reflect this. However, turnover and operating profits show a positive trend between 2016 and 2017 and the balance sheet as at 31 Mach 2017 reports net assets of over £200m.

The next section of this report analyses the financial results further, considering key operating and liquidity ratios.

4. Financial Standing

4.1 Size of Contract

The OJEU notice for the Development and Regeneration Programme allows for a maximum programme/contract value of £200m over a potential 20-year period. The revenue of KHL for the year ended 31 March 2017 is £413m. When assessing the size of a company in relation to a proposed build or development contract, we would expect annual turnover to be at least 3 times the annual contract value. If the £200m maximum contract value was incurred over the initial 10-year period, the ratio of turnover to proposed annual contract value is 20.6 which is sufficient to comfortably satisfy this test.

4.2 Financial ratios

The financial ratios set out below have been used to highlight any potential areas of concern in Keepmoat's financial performance. The ratios have been calculated based on KHL accounts, and where deemed relevant, for Keepmoat Limited.

The following ratio groups have been considered:

- *Profitability ratios* – measure the company's use of its assets and control of its expenses to generate an acceptable rate of return.
- *Liquidity ratios* – measure the availability of cash to pay debt obligations.
- *Activity ratios* – measure the effectiveness of the firm's use of resources.

Profitability ratios

KHL

Ratio	2017	2016	2015
Gross margin	20.3%	18.1%	18.3%
Operating margin	10.0%	7.4%	8.7%
Return on capital employed	30.7%	28.9%	33.2%

The profitability ratios are relatively consistent year on year. Analysis of a sample of housebuilding companies shows that the gross and operating margin for KHL are towards the lower end of the range for similar companies. The sample analysed had operating margins from 0.3% to 26.2%. As KHL's housing mix is targeted at first-time buyers, first time movers and registered providers of housing, then this would be expected and the operating margins reported do not give cause for concern.

Liquidity ratios

KHL

Ratio	2017	2016	2015
Current ratio	1.49	1.44	1.40
Quick ratio	0.31	0.36	0.48

The current ratios set out above are more than 1, and have improved slightly over the three years analysed. They therefore look reasonable and do not suggest any cause for concern.

The quick ratios are below 1 for each of the three years considered. The difference between the current and the quick ratios is due to KHL having significant balances for inventory which are included in the current ratio but excluded from the quick ratio.

For 2017, inventory includes £143.6m of land held for and under development and £148.7m of house building work in progress. Current liabilities of £248.6m are therefore well in excess of current assets excluding inventory of £77.7m. This suggests that KHL would be unable to meet its current liabilities from its liquid current assets if the situation arose.

House building companies typically carry large development land and work in progress balances, so this low quick ratio is not unusual in the sector. We have analysed the accounts of a number of housebuilders active in the market, and quick ratios were between 0.27 and 0.84. The quick ratio for KHL is therefore within this range.

In addition, the quick ratio will also depend on the timing of the accounts, ie if a number of projects have started or are about to start imminently, then the level of land held for development will be higher, and set up costs and subcontractor costs may have been incurred without any work being capable of being invoiced or paid for.

As Parent Company Guarantor, we have also considered the liquidity of Keepmoat Limited, and these are set out below.

Keepmoat Limited

Ratio	2017	2016	2015
Current ratio	1.85	1.21	1.36
Quick ratio	0.72	0.77	0.95
Operating Cash Conversion %	13.1%	71.2%	107.6%

The quick ratio for Keepmoat Limited is therefore higher than for KHL, but still below 1. The Keepmoat Group also has the revolving credit facility of £75m. At 31 March 2017, the undrawn facility was £49.4m. Including this gives a quick ratio of 0.91.

As noted above, in the sample of house building companies analysed, the quick ratios ranged from 0.27 to 0.84. The quick ratio for Keepmoat Limited is towards the top end of this range.

In addition to the current and quick ratios, the Operating Cash Conversion % has also been calculated for Keepmoat Limited. KHL does not have to provide a cashflow as part of its statutory accounts, so this has been done at Keepmoat Limited level only.

The Operating Cash Conversion % gives an indication of how well a company converts its profit to cash. The range of housebuilders analysed had Operating Cash Conversion percentages of 34% to 70%, with an average of 50%. The ratio for Keepmoat Limited in 2017 is low compared to the range, but is distorted by the disposal of the Regeneration business. The ratio for 2016 and 2015 were favourable when compared to others, which gives comfort, but this may be an area the Council wishes to monitor going forwards.

4.3 Gearing

The gearing ratios for KHL are shown in the table below:

Ratio	2017	2016	2015
Interest Cover	14.76	24.39	-
Gearing (Debt/Equity)	0.07	-	-

These ratios suggest that KHL has a very low level of debt compared to shareholders equity and that it can easily pay its interest.

Details of the financing of the group are explained in Section 2.2. The consolidated financing position of the group is shown in the Keystone JVCo accounts. At 31 March 2017, this showed total loans and borrowings of £302m. The notes to the accounts include post balance sheet events which have repaid £178m, leaving £124m, which therefore improves the gearing ratio.

4.4 Credit rating

Dun & Bradstreet

The Council provided Dun & Bradstreet reports as at 6 November 2017 for KHL, the preferred bidder, and for Keepmoat Limited, providing the parent company guarantee.

Keepmoat Homes Limited

The report for Keepmoat Homes Limited provided the following key credit scores:

- D&B rating = 5A 1
- Financial strength = 5A (based on tangible net worth of £91.344m)
- Risk indicator = 1 (minimum risk of business failure)
- D&B failure score = 98 out of 100 (2% of UK businesses have a lower risk of failure)
- Incidence of failure = 0.10%
- D&B delinquency score = 5 out of 100 (95% of businesses have lower risk of paying significantly late)
- Incidence of delinquency = 26.12%

The report is positive as to the credit rating of KHL, with a minimum risk of business failure score. The incidence of failure above shows that 10 out of 10,000 businesses with this Failure Score have been subject to an insolvency event or gone out of business with outstanding debt.

Keepmoat Limited

The report for Keepmoat Limited provided the following key credit scores:

- D&B rating 5A 1
- Financial strength = 5A (based on tangible net worth of £252m)
- Risk indicator = 1 (minimum risk of business failure)
- D&B failure score = 87 out of 100 (only 13% of UK businesses have a lower risk of failure)
- Incidence of failure = 0.34%
- D&B delinquency score = 56 out of 100 (44% of businesses have lower risk of paying significantly late)

- Incidence of delinquency = 2.83%

The report is positive as to the credit rating of Keepmoat Limited. The incidence of failure above shows that 34 out of 10,000 businesses with this Failure Score have been subject to an insolvency event or gone out of business with outstanding debt.

4.5 Summary

Our detailed analysis of the financial statements of and calculation of key ratios for KHL and Keepmoat Limited have highlighted that the quick ratio and Operating Cash Conversion % were relatively low in 2017. However, the Keepmoat Limited position may be distorted due to the disposal of the Regeneration division shortly after year end (which was incorporated in the 2017 accounts as the transaction had occurred prior to signature of the accounts). In addition, quick ratios in housebuilders are known to be low due to the need to acquire land and incur costs prior to realisation of income.

Overall, we are therefore satisfied as to the financial standing of KHL and Keepmoat Limited, although we would recommend that the liquidity position of both is monitored on release of new financial information.

5. Other

5.1 2017 Budget

The key points announced in the Budget on 22 November 2017 relating to Housing are:

- £28m in 3 new ‘Housing First’ pilots in West Midlands, Manchester and Liverpool
- £630m small sites fund to facilitate delivery of 40,000 homes
- £2.7bn to more than double the Housing Infrastructure Fund
- £400m for estate regeneration
- £1.1bn to unlock strategic sites
- £8bn of new financial guarantees to support private house building and purpose-built private rented sector
- £34m to develop construction skills.

These announcements are likely to have a positive impact on the industry as a whole and it appears that KHL is well positioned to take advantage.

5.2 Press searches

We have conducted a press search in order to highlight if there are any press releases that reflect negatively on KHL or Keepmoat Limited from a financial perspective. Our search did not highlight any areas for concern.