TORONTO

STAFF REPORT
ACTION REQUIRED

Start-Up Financing for Build Toronto

Date:	August 3, 2010
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2010\Internal Services\SP\EC10002SP (AFS-9618)

SUMMARY

This report responds to a direction from Council that staff report annually on the amount and purpose of draws by Build Toronto ("Build") and Invest Toronto from the $10 million start-up allocation originally approved by City Council.

It also responds to a request from the Board of Build that the City provide additional start-up financing assistance in the form of a $200 million loan guarantee program. This report recommends approval of an agreement under which the City would guarantee loans up to a total maximum value of $160 million. This is the amount that Build has indicated will be necessary during the first five years of Build's development program.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. Subject to the City obtaining the requisite statutory authority from the Province of Ontario, City Council approve providing loan guarantees in respect of debt to be incurred by Build Toronto to finance its equity investments in various Build projects, and to enter into an agreement with Build whereby the City agrees to provide such loan guarantees (the "Agreement"), on the following principal terms and conditions:

    a. maximum amount guaranteed by the City not to exceed $160 million (inclusive of interest, costs and charges);

    b. the term of the Agreement be five years, following which the City will no longer guarantee any new Build debt unless Council has elected to extend the Agreement;

c. each individual guarantee provided by the City under the Agreement expire no later than five years from the date it is issued;

d. Build to pay to the City, as consideration for the Agreement and the guarantees, a fee equal to 1.0% per annum on the average outstanding loan balances being guaranteed by the City from time to time;

e. Build to provide to the City collateral with appraised value equal to or greater than the amount of the loans being guaranteed by the City;

f. prior to each new guarantee being issued, Build must certify that the existing collateral for previously issued loan guarantees still meets the requirement in (e), or, in the alternative, provide additional collateral to meet the requirements in (e);

g. the certifications in (f) be confirmed by full appraisals of the entire collateral lands, at Build's cost, and carried out by a third-party appraiser selected by the City, at such time as the total amounts guaranteed by the City reach $40 million incremental thresholds (e.g. $40 million, $80 million, $120 million);

h. the City to have the right to terminate the granting of new loan guarantees on ninety days notice; and

i. any other term deemed appropriate by the Deputy City Manager and Chief Financial Officer.

2. The loan guarantees to be provided pursuant to the Agreement be deemed to be in the interests of the City.

3. Authority be granted to the Deputy City Manager and Chief Financial Officer to enter into any agreements or documentation between the City, Build and Build's lenders as may be required, desirable or necessary in respect of individual guarantees to be provided by the City, and collateral to be taken by the City under the Agreement.

4. The Deputy City Manager and Chief Financial Officer report back to Council prior to the expiry of the five year term of the Agreement with an assessment of the potential risks and benefits associated with an extension of the Agreement for a further five year period.

Financial Impact

Over the next five years, Build has forecast that it will require loans with a total value of up to $160 million to finance the corporation's equity investments in its proposed projects. In order to provide for the lowest borrowing cost, and to leverage the value of its available land collateral, Build has requested that the City provide guarantees to the lenders providing this funding.

By entering into the requested loan guarantee Agreement, the City will be committing, in the event of a loan default by Build, to pay up to $160 million to Build's lenders, to cover any of Build's outstanding loan liabilities.

However, before providing each individual loan guarantee to Build's lenders, the City will require Build to provide collateral, primarily in the form of undeveloped property, with an appraised value that is at least equal to the amount of the loan being provided by the lender and guaranteed by the City. In the event of a loan default by Build, the City will be required to remedy the default using its own funds. It will then have access to the land collateral that has been set aside by Build. This land collateral could be liquidated by the City or held until it can be developed and sold more profitably.

With the large amount of collateral being provided by Build, it is very unlikely that the City would not have access to collateral at least equal in value to any amounts it has been required to pay to Build's lenders under the proposed loan guarantees. However, under extremely adverse economic conditions, there is a possibility that the value of Build's land collateral could fall during the term the Agreement. In this event, the City would be exposed to the potential shortfall between the outstanding loan amount and the diminished value of the collateral.

The Agreement with Build will require a reassessment by Build of the value of the collateral backing all outstanding guarantees each time a new guarantee is drawn from the City. Build will be required to certify that the value of the collateral provided to the City remains at least equal to the amount of the loans guaranteed by the City. When the total amounts guaranteed pass $40 million incremental thresholds (e.g. $40 million, $80 million, $120 million), these certifications will have to be backed by full appraisals of the collateral lands carried out by a third-party appraiser selected by the City. This should help limit the size of any potential shortfall between the liability of the City under any guarantees provided under the Agreement and the value of the land collateral.

Furthermore, through its business plan, Build has indicated that it will only pursue projects that are forecast to generate a solid financial return and which fall within Build's principal areas of focus and expertise. Build will spread risks on more complex projects by entering into joint venture partnerships.

In return for providing the loan guarantees, Build will be paying the City an annual fee equal to 1.0% of the average outstanding loan balance being guaranteed at any point in time. Thus, in the absence of a default, the loan guarantee Agreement should result in a positive financial impact for the City.

The small risk of a default must be weighed against the various benefits that will arise from Build's projects. If Build's projects are successful, the City will receive financial dividends that will significantly improve upon the financial outcomes that would have been realized if the City had simply sold its surplus properties in an unimproved state. Furthermore, unlike conventional developers, Build will be striving in its development projects to achieve important social, environmental and economic development objectives on behalf of the City and its agencies, boards and commissions.

Finance staff have discussed the proposed loan guarantee agreement with representatives of the major bond rating agencies and they currently anticipate that the agreement will not result in a material impact on the City's credit ratings.

DECISION HISTORY

At its meeting of October 29 & 30, 2008, City Council adopted the recommendations within the staff report on the "New Model to Enhance Toronto's Economic Competitiveness". One of the recommendations within that report was that "City Council allocate $10 million to the non-program expenditure budget to be funded from the Land Acquisition Reserve Fund, to be disbursed to Build Toronto and Invest Toronto, on terms satisfactory to the CFO, for the purpose of setting up and commencing business operations including development of a business plan that identifies sustainable revenue sources".

At its meeting of February 23, 24, and 25, 2009, City Council adopted a motion that "The Deputy City Manager and Chief Financial Officer be requested to report annually on the amount and purpose of draws by Build Toronto and Invest Toronto from the $10 million start-up allocation approved by City Council".

ISSUE BACKGROUND

Following the creation of Build in 2009, Build staff began preparing a Strategic Plan for the initial 5-year period of Build's operations. One of the objectives established in this plan was to achieve operational self-sufficiency by 2013 so that the corporation would no longer require funding from the City's Land Acquisitions Reserve Fund (LARF). As discussed above, Council has approved withdrawals by Build of up to $10 million from the LARF account.

As shown in Table 1, Build had, as of December 31, 2009, made $1.838 million in expenditures which will be funded from the LARF. The full $10 million authorized by Council is forecast by Build to be utilized by the end of 2012 (see Table 2).

Table 1 - Uses of Build Toronto LARF Start-Up Funds Up Until December 31, 2009

Category	Amounts ($000's)
Salaries and Benefits (development staff)	506
Organization Costs (recruitment, legal etc.)	289
Investigative and Pre-Development Costs (e.g. appraisals, environmental and geotechnical assessments)	1,043
Total:	1,838

Table 2 – Forecast Uses of Build Toronto LARF Start-Up Funds ($ millions)				
	2010	2011	2012	Total
Salaries and Benefits	1.0	0.8	0.4	2.2
Investigative and Pre-Development Costs	1.5	2.0	2.5	6.0
Total:	2.5	2.8	2.9	8.2

In order to achieve operational self-sufficiency, Build will need to generate significant revenues to offset its operating costs. Therefore, Build has indicated to City staff that it is imperative that larger projects, with high Build Toronto equity participation, start into production.

In order to put these projects into production, Build has forecast that it will need to borrow up to $75 million to fund its equity investments in these projects over the next three years. The total borrowing for equity requirements is forecast to reach $160 million by year five.

Currently, Build has very limited cash resources. However, later in 2010, Build will receive land transfers from the City with a value, according to Build, of approximately $170 million.

Build has investigated the possibility of raising the necessary equity funds by borrowing against the value of these lands. However, lenders currently require a very high asset coverage ratio for such loans. This means that the appraised value of the assets being pledged as collateral must be several times higher than the value of the loan. Part of the reason for this requirement is a more conservative approach by lenders toward lending against any type of land assets. However, lenders also see a particularly high risk in accepting unimproved lands, such as those likely to be pledged by Build, as collateral. Under the extreme economic conditions that are likely to result in loan defaults, lenders expect that unimproved lands will have lower liquidity (ie. they would be harder to sell) and have higher potential variability in value than developed lands with established revenue flows (such as completed office or apartment buildings).

In addition to requiring a high asset coverage ratio, lenders would also likely require a relatively high interest rate on a loan backed only by unimproved land assets. These high loan rates would reduce the return on investment to Build, and therefore to the City, in the form of financial dividends.

In order to avoid these onerous requirements, Build has proposed that the City agree to provide loan guarantees to Build's lenders for the estimated total amount of Build's equity loans ($200 million) for a ten-year period. Build has committed to offset the risk to the City by providing land collateral that would have a value of at least the amount of the equity loans guaranteed by the City. In the event of a default, the City would initially be required to remedy the default using its own funds. It would then have access to the land collateral that has been set aside by Build. This land collateral could be liquidated immediately by the City or held until it can be developed and sold more profitably.

The City currently lacks the requisite statutory authority to guarantee Build's debt. Accordingly, an amendment to Ontario Regulation 295/09 is required to expressly provide the City with the requisite authority. The Mayor has requested this amendment in a letter to the Premier dated February 23, 2010 and staff are awaiting a response from the Province.

COMMENTS

Risks Associated with the Proposed Loan Guarantee Agreement

The main underlying risk associated with the proposed loan guarantee Agreement is the possibility that extremely adverse economic and real estate market conditions might be experienced during the term of the Agreement.

Such conditions would lead to an increased potential for a loan default and these conditions would also lead to a greater possibility that the value of the land collateral provided to the City would experience a significant decline.

These conditions could expose the City to a potential shortfall between the value of the outstanding loans guaranteed by the City and the value of the collateral provided by Build. However, a number of measures are recommended to be incorporated in the proposed Agreement to limit this potential exposure.

The first of these measures is to limit the value of loan guarantees initially extended to Build to the amount required during the first five years of Build's proposed development program. Build's financial forecast indicates that this initial amount will be approximately $160 million. Staff are recommending that, after five years, Council be provided by staff with a re-assessment of the potential risks prior to reaching a decision on whether to extend the agreement for a further five years.

A second measure is to require that Build reassess the value of the collateral pledged for all outstanding loans each time a new guarantee is requested of the City. If this reassessment indicates a decline in collateral value, Build will be required to add collateral for the outstanding loans before they enter into any new loans. The proposed guarantee agreement will also provide the City with the right, upon sixty days notice, to terminate the agreement and stop the issuance of new loan guarantees (loan guarantees already in place would remain in effect).

While some risk of a default and a collateral shortfall will remain, the City will, as a result of its relatively long investment time horizon, be better able to absorb this risk than a bank. Instead of liquidating the collateral under adverse market conditions, the City would have the ability to potentially hold onto these assets until market conditions improve. The City can then either liquidate the assets or have them redeveloped for a potentially greater profit.

Benefits Arising from the Proposed Loan Guarantee Agreement

As discussed above, Build has forecast that the proposed equity loan amounts will allow Build to achieve operational self-sufficiency by 2013. By 2016, Build has forecast that its operations and investments will begin generating a steadily growing free cash flow that will allow Build to repay the LARF funds and produce significant dividends for the City.

Build staff have forecast that their development program will result in returns on investment of between 6.5% and 8.5%. This outcome would leave the City significantly better off financially than if the surplus properties were instead sold in an unimproved state and the sale proceeds were immediately applied towards the City's outstanding debt.

Furthermore, the development projects that are created by Build will achieve other important objectives for the City. For instance, Build has committed in its Strategic Plan to producing buildings that have a level of energy consumption that is 40% below the National Model level of consumption and that will exceed the City's own Green Building standard.

Conclusions

Subject to obtaining the requisite statutory authority, it is appropriate for the City to provide the loan guarantee Agreement being requested by Build. As discussed above, a number of important risk mitigation measures are recommended to be incorporated in the proposed loan guarantee Agreement. As a result of these risk mitigation measures, it is expected that the overall risk faced by the City as a result of the proposed Agreement will be relatively low. This low level of risk will be more than offset by the potential financial, social, environmental, and economic development benefits arising from Build's proposed projects.

CONTACT

Joe Farag, Director of Special Projects
Tel: 416-392-8108 Fax: 416-397-4465 Email: jfarag@toronto.ca

SIGNATURE

____

Cam Weldon
Deputy City Manager and Chief Financial Officer