

Breakout 3: Capital funding and investor relationships

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Canaccord Debt Markets

Capital Funding and Investor Relationships

Maintaining Access to the Capital Markets

9 July 2013

London Finance
Conference

Approach to the capital markets

Why does it matter

Cost

Flexibility

Predictability

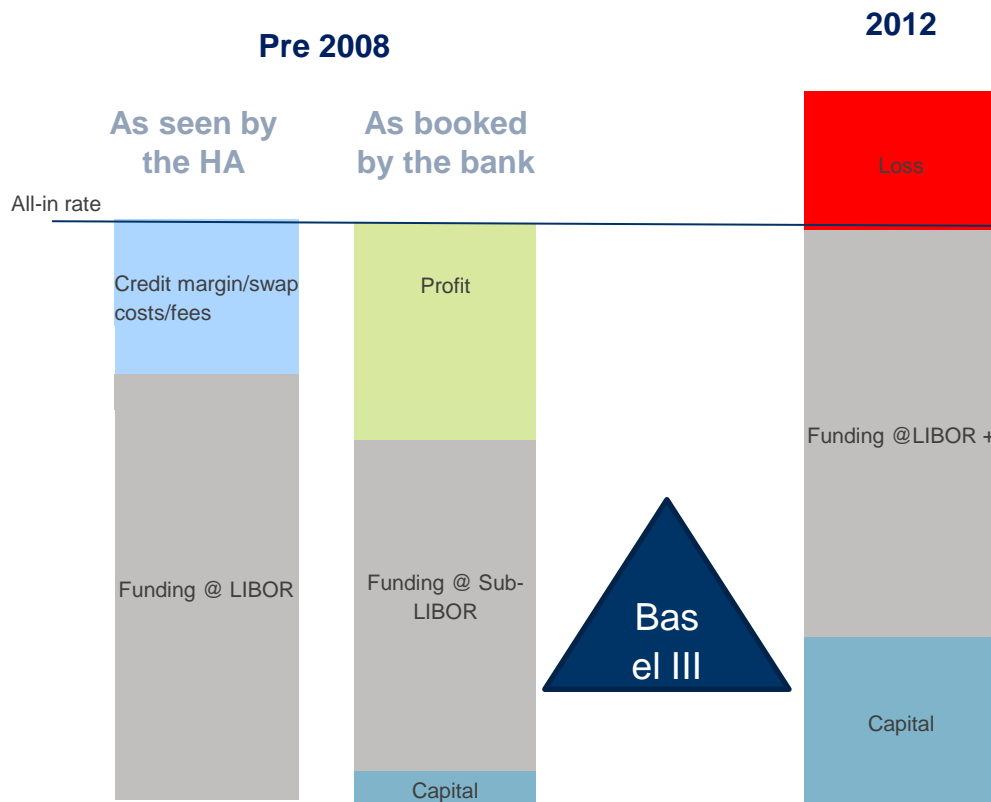
“Know thy Lender”

Recap – Understanding the changing landscape

Why the capital markets - recap

Attractions of lending to Housing Associations then and now

Fixed Rate Loan

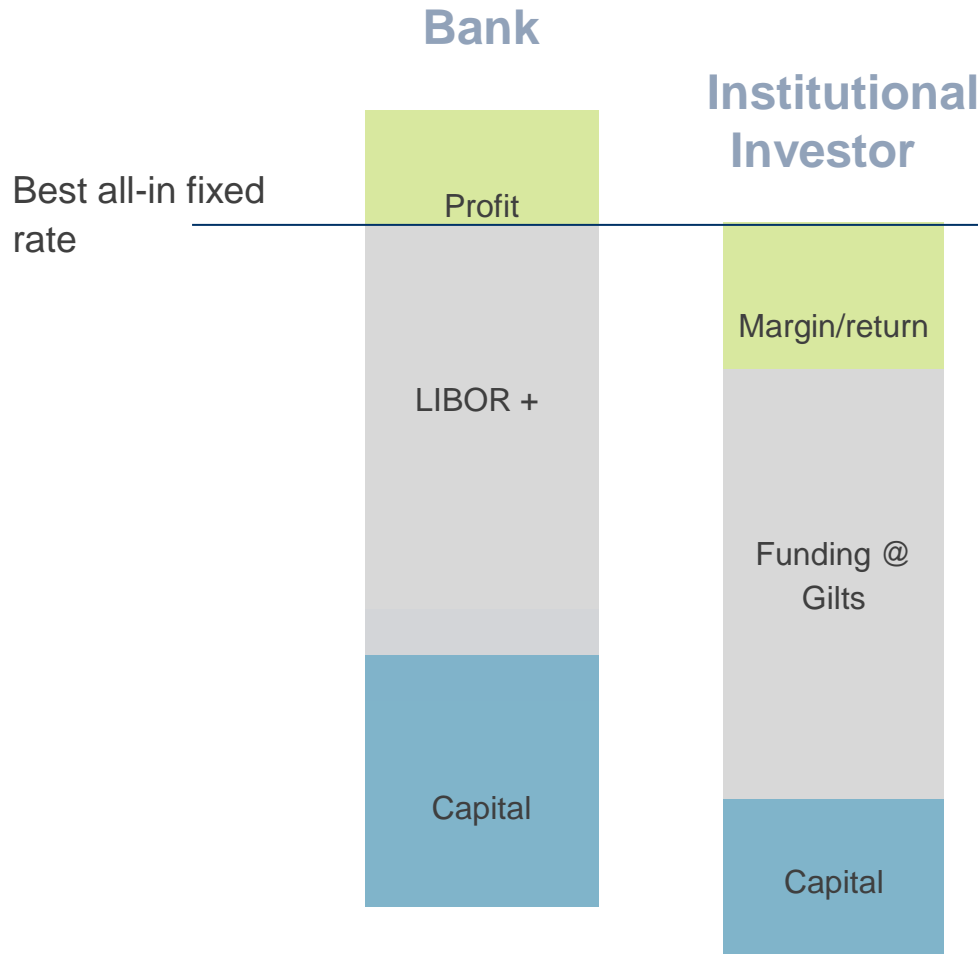


- Pre 2008 Lending to Housing Associations was profitable for banks especially where there were fixes involved
- Post 2008 everything goes wrong for banks:
 - Funding at Libor + enormous margins
 - Increased regulatory capital especially for long dated loans
 - Increased swap provisions
 - Cost of unmatched collateral on embedded swaps

NOT TO SCALE!

Why the capital markets - recap

Now – Capital markets are a cheaper source of long term debt



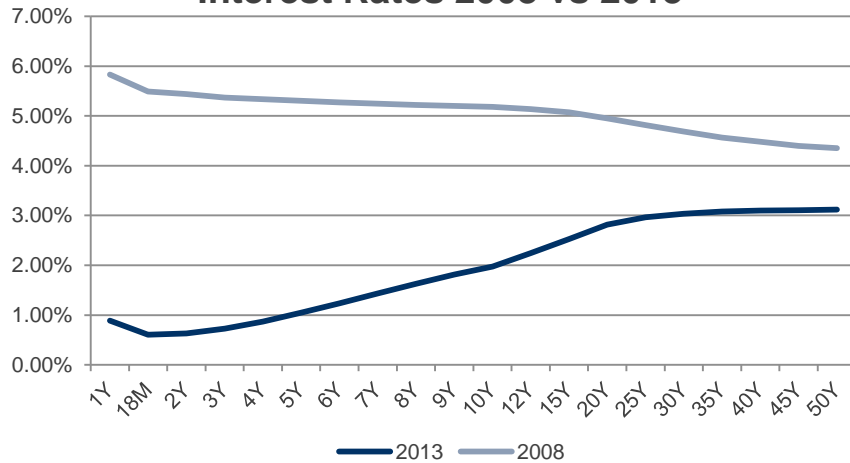
- While banks are funding at close to LIBOR again, regulation still makes it expensive for a bank to lend long term to a Housing Association
- NB though not to lend short term!!!
- Long term investors also have a capital cost

NOT TO SCALE!

Why the capital markets - recap

Cost and competition

Interest Rates 2008 vs 2013

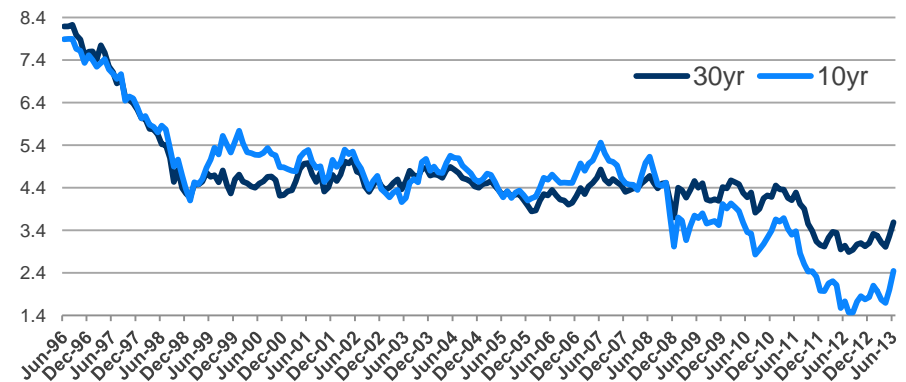


QE has had two affects on the capital markets

- It has driven down long term interest rates
- It has put cash into the hands of institutional investors
- At the same time, regulators have encouraged a move to fixed income

Banking Lenders	Pre 2007	2013	Institutional Investors	Pre 2007	2013
No. Lenders	11	6	No. Lenders	25	50
Margin	30-50	165-250	Yield	6.75%	4.40%
Term	30 years	5- [10] years	Term	30+	5-40+

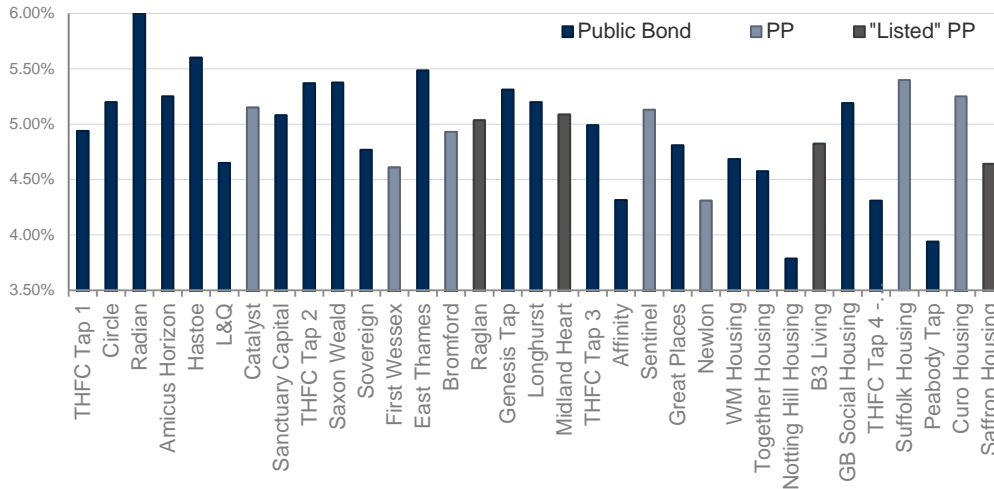
30yr & 10 yr Gilt Yields



Why the capital markets - recap

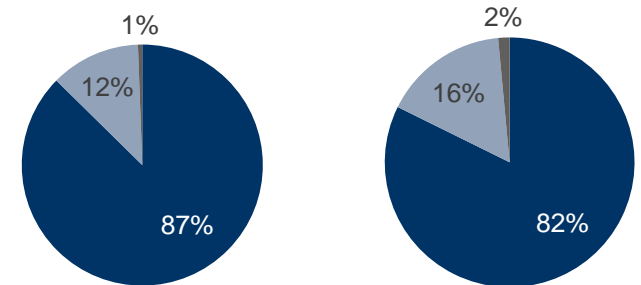
Cost and Competition

Yields on New Issues 2012/13

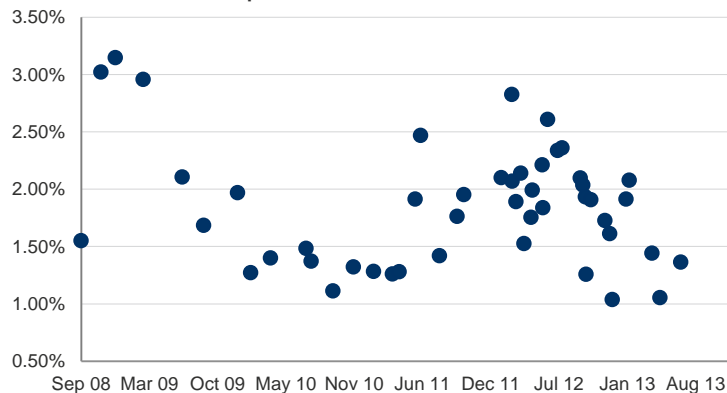


HA Sector Sources of Funding 2010 & 2012

Bank loans (drawn) Bonds Private Placements



Spread to Libor on New Issues

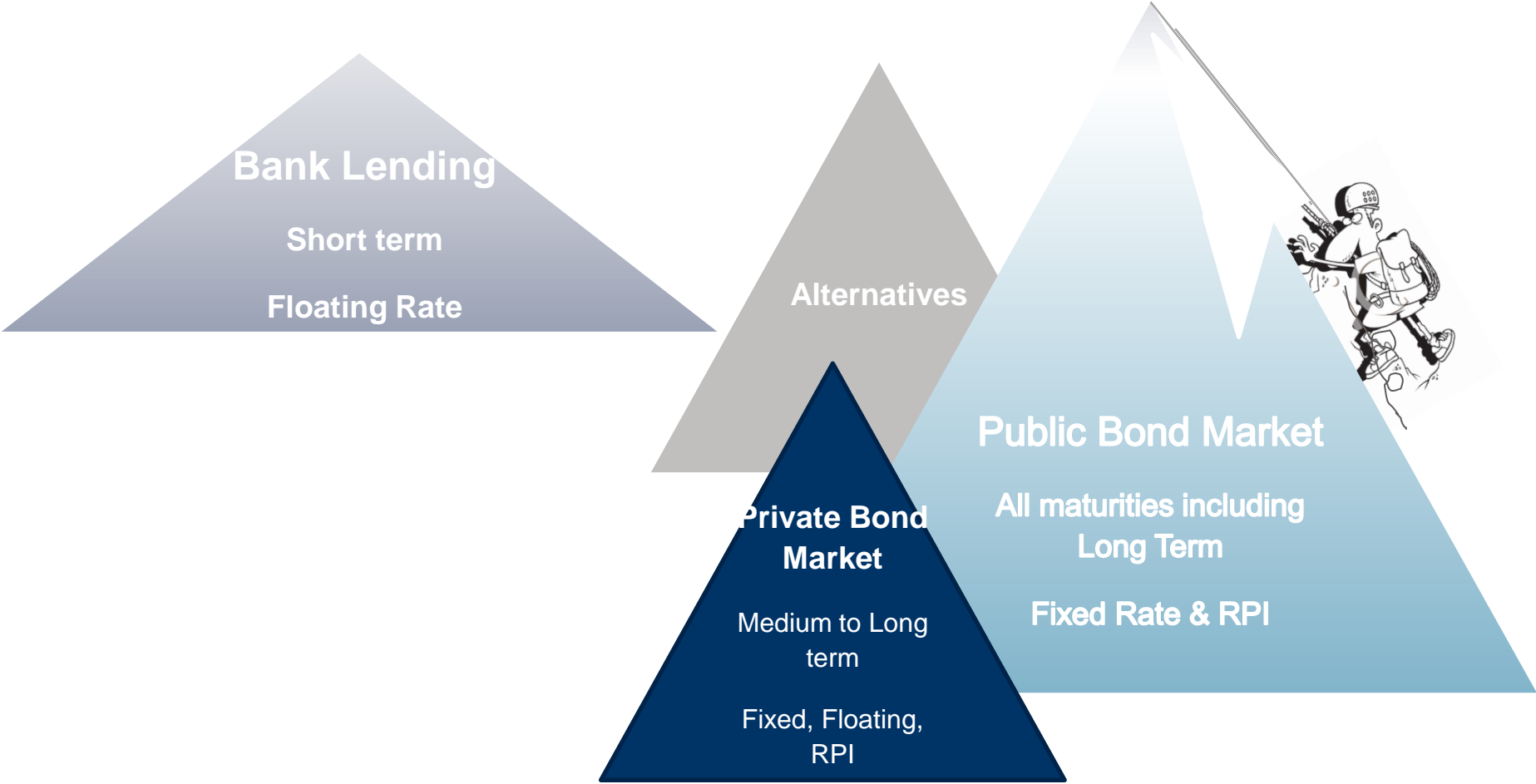


- Housing association bonds were 25% of long term sterling issuance in 2012
- Investors who had never invested in the sector (or not for years) came back into the market.

The New Landscape

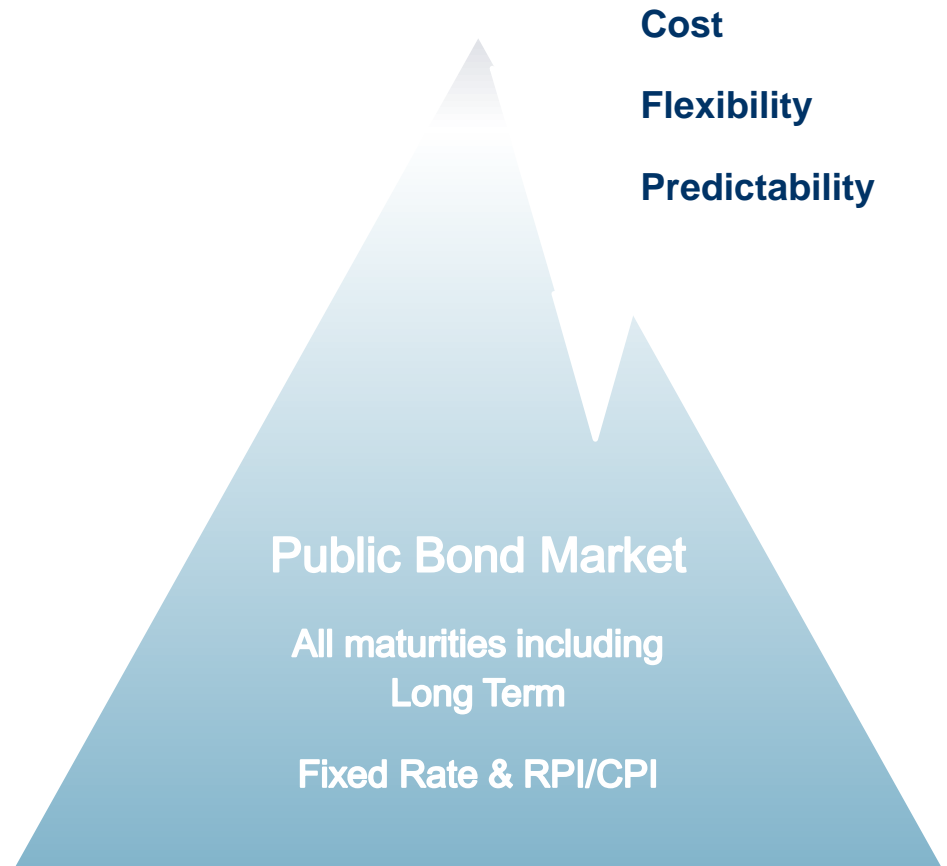
The new lending landscape

The Approach



Institutional Investors

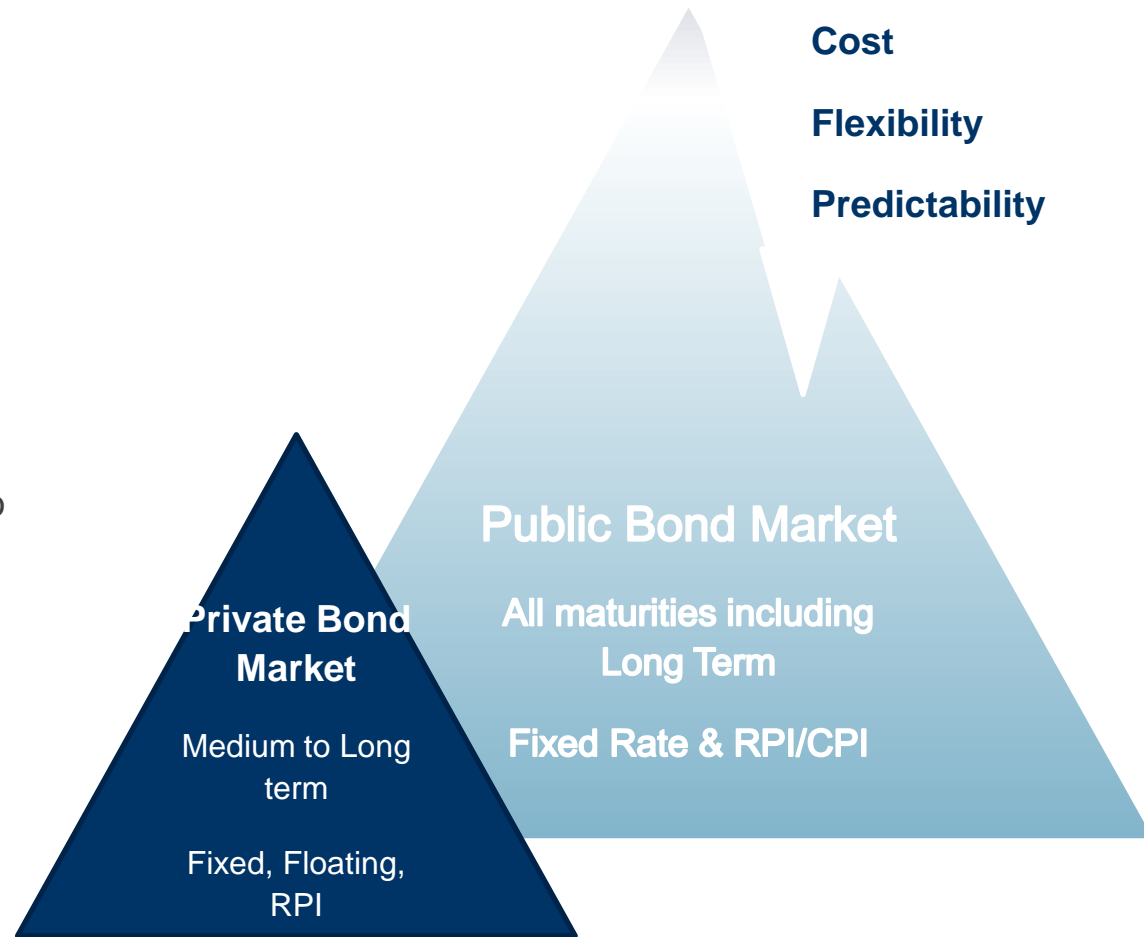
- Approximately 50 medium and long term investors
 - Asset managers
 - Insurance companies – general, life, annuities
 - Pension Funds
- With a constant need for assets
 - Medium to long term
 - Fixed rate or index linked
 - Stable, Non cyclical, Diverse
- Like “liquidity”
 - Listing
 - Large size
 - Rating
 - Index eligible
- Not set up as relationship lenders
 - Want to be very passive



They don't want their money back before the maturity date

Institutional Investors – Private placements

- A fast growing subset of the investor base
 - US & UK Lenders
- Buying
 - Public bonds in the market
 - Traditional private placements
 - Listed private placements
 - Loans
- 3x as many active as 18 months ago
- Exactly the same needs but
 - Will commit margin ahead of documentation
 - Happy to lend in smaller amounts
 - More focussed requirements
 - Like amortising structures
 - Will offer deferred drawdowns
- Want a relationship as they may be a material lender to the HA



They don't want their money back before the maturity date

Market Update

Capital Markets

Retail Bonds

- Rating almost certainly required
- Listed issue
- Short to medium term borrowings
- Unsecured
- Light covenant package
- Increased brand awareness and engagement with stakeholders

Public Bonds (wholesale)

- Rating required
- Listed issue
- Medium to Long maturity
- Covenant light if security is provided
- Pledging security can be very time consuming
- Generally fixed (or RPI-linked)
- Large individual transactions preferred
- 20+ investors

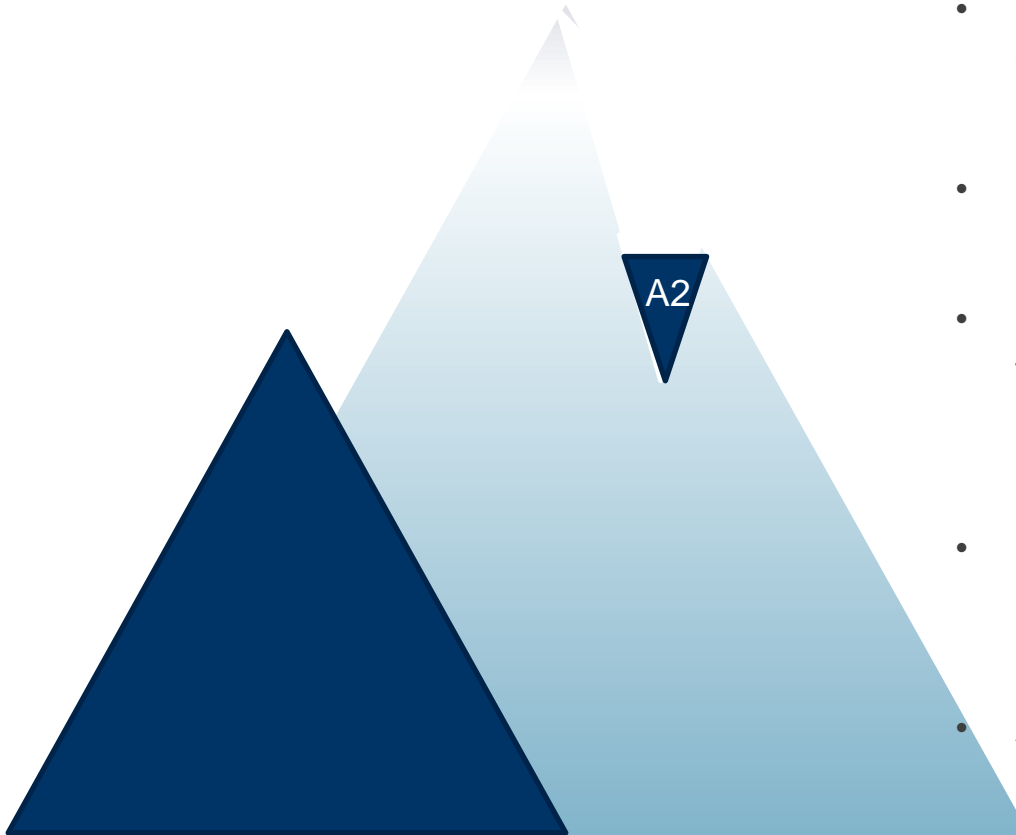
Listed Private Placement

- Credit rating required
- Listed issue
- Marketed directly to a small group of investors
- Delayed drawdown available
- Up to 50% of retained bonds – for future borrowings
- No road show or marketing
- Medium to long maturity
- Security required

Private placement

- No requirement for a public rating
- Unlisted, private loan stock issue
- US & UK investors compete to lend in sterling
- 10 – 30 years (borrowing in Sterling)
- Multiple maturities in a single issue
- Delayed drawdown possible
- Covenant package agreed between borrower and lenders

Ratings



- Ratings open up more ways of tackling the capital markets
- Improves access and predictability of access
- Rating agencies, like long term investors, become a new stakeholder in your business
- Public or private, it is a statement about your business
- Affects the way you run it

Alternatives

- Increasing number of alternatives
- Some genuinely new sources of finance
 - Increased funds and funding routes from EIB
 - New investors
- Some a variation on a theme
 - But increase competition
 - Increase the alternatives available
 - Potentially reduce cost or offer flexibility or a way around covenants
 - Government guarantee
 - Old investors with new facilities
 - Sale and Leaseback

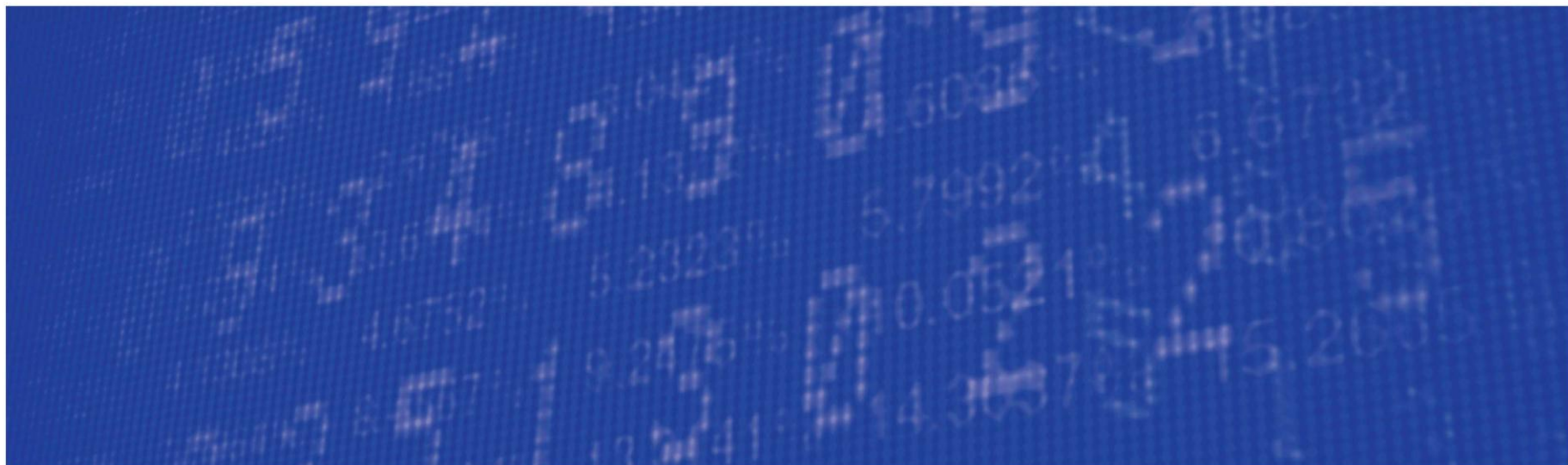
Importance of developing new relationship

Obtaining best price and terms

- Understand the pros and cons of each market
- Use an adviser who really understands all the capital markets available
- Get to know some of the investors now – they want to know about what is going on in the sector
- Let the adviser obtain your credit rating
- Select an agent/lead manager with the aid of the adviser who
 - Has good relationships with the investors, and
 - Is motivated to get the best deal and/or
 - Who may offer alternative or additional facilities
- Make sure you and the adviser are running the deal

Maintaining Access

- Treat your investors and the rating agencies as important new stakeholder
- Maintaining a credit rating is likely to affect the way you run and present your business
- Keep the agencies and investors up to date and in touch with developments
- Markets change - meet new investors



English Housing Associations

Elizabeth Bergman
National Housing Federation

Agenda

1. Approach to rating English housing associations
 - Baseline credit assessment
 - Likelihood of government extraordinary support
2. Portfolio of Moody's rated issuers
3. Changing environment
4. What we expect looking forward

Baseline Credit Assessment (BCA)

1. Institutional factors (government constraints)
2. Issuer profile
3. Financial performance
4. Debt and liquidity
5. Governance and management

BCA - Institutional factors

Regulatory framework is strong

- Level of oversight / inspection (strong)
- Powers of intervention (wide-ranging)
- Track record (extensive)

Revenue flexibility is low

- Control over SH rents – low, set by policy (affordable rent upside in long term)
- Control over other revs – variable (market-driven), subject to viability check

Expenditure flexibility is moderate

- Short-term, moderate: cash management, maintenance as plug; flexible use of financing
- Long-term, low: maintenance of properties, market costs on labour, materials, regulation on standards

System indebtedness is high

- Use of leverage for social mission

BCA - Issuer profile

Size

- Economies of scale
- Labour market
- Development programme

Geographical distribution

- Concentrated v widespread
- SH rent v market rent
- SH demand

Governance structure

- strong parent v federation

Growth strategy

- organic v inorganic
- traditional v LSVT

BCA - Financial performance

Revenue analysis

- » Annual growth
- » By type (SH letting v other higher-risk activities)
 - SH letting (low risk)
 - Development-for-sale (high risk)
 - Temporary housing, care, student accommodation, private rent, shared ownership (low-to-high risk)

Profitability

- » Operating margin
- » Total margin

Capital spending

- » Net burden to revenues
- » Spending on existing properties v new development

BCA – Debt and Liquidity

Debt

Scale: Debt to revenues

Recovery: Debt to assets (adding back social housing grants)

Debt structure

- » Maturity profile
- » Fixed v floating
- » Use of derivatives (embedded v stand-alone); mark-to-market exposure
- » Off-balance sheet liabilities (JVs)

Affordability: Interest coverage ratios

- » SH letting interest coverage – reliance on lower-risk activities
- » Recurrent cash interest coverage (long-term) – cash flow, excluding working capital
- » Cash interest coverage (short-term) – cash flow, including working capital

BCA – Debt and Liquidity

Interest coverage types

Type I (Mid investment grade BCA)

- » Strong/adequate interest coverage
- » Low-risk SH letting/typical operations sufficient to cover interest

Type II (Low investment grade BCA)

- » Weak interest coverage
- » Reliance on high-risk activities and/or non-recurrent asset sales to cover interest

Type III (High speculative grade BCA)

- » Very weak interest coverage
- » Reliance on new debt and/or tapping of existing reserves to cover interest

BCA – Debt and Liquidity

Liquidity

- » Cash on-hand
- » Undrawn facilities (fully-secured v to be secured)
- » Potential liquidity from unencumbered properties (EUV-SH / MV-T)

BCA - Governance and management

Financial management

- Variance analysis (results close to budget)
- Internal controls / risk analysis / board controls over subsidiaries

Investment and debt management

- Aggressiveness of development programme
- Prudent treasury policy

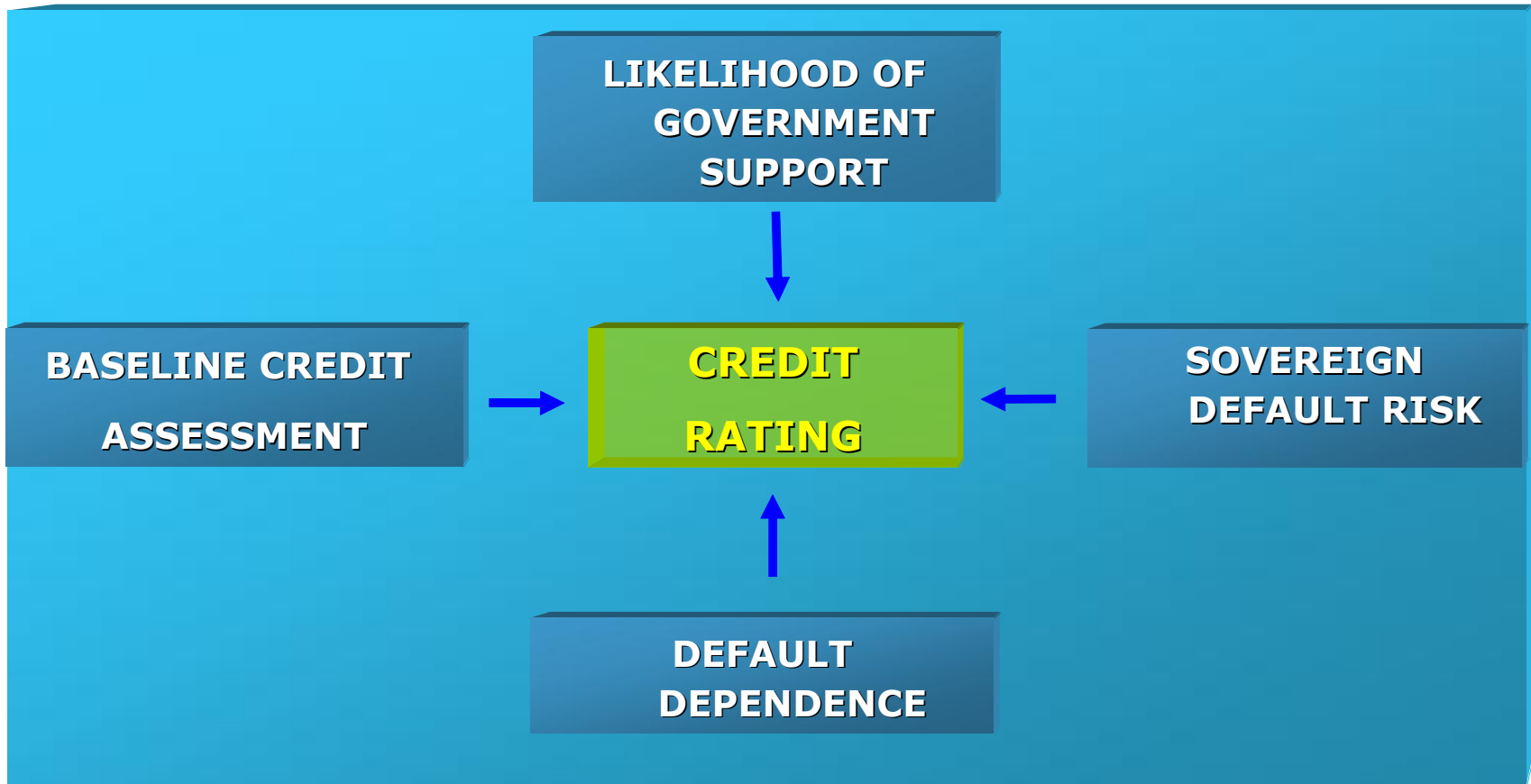
Transparency and disclosure

- Clarity in reports / documents / discussion
- Clarity (internal v external)

Scorecard for fair consideration – *not rating*

	Factors	Sub-factors
1	A. Institutional framework	Regulatory framework
2		Revenue flexibility
3		Spending flexibility
4		Extent of Borrowing
5	B. Issuer profile	Size
6		Geographical distribution
7	C. Financial performance	Reliance on low-risk activities: % revenues
8		Reliance on low-risk activities: interest coverage
9		Operating margin
10		Total margin
11		Capital expenditure
12	D. Debt and liquidity	Debt burden
13		Gearing
14		Long-term interest coverage: Recurrent cash interest coverage
15		Short-term interest coverage: Cash interest coverage
16	E. Governance and management	Financial management
17		Debt management
18		Transparency and disclosure

Joint Default Analysis (JDA) framework



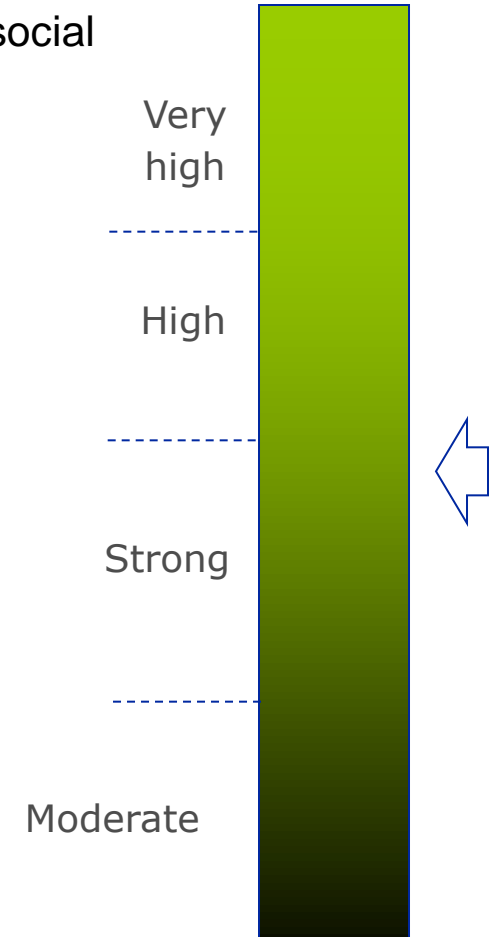
Likelihood of government extraordinary support

Links to Government

- » No direct ownership, but significant government equity/funding (social housing grant)
- » Special status and legislation
- » Social mission and strong regulation

Moody's evaluation of probability that ultimately government would step in :

- » Government policy toward intervention, and track record
- » 28 days moratorium
 - » protection of social housing assets
 - » Alignment of government and creditors interests
- » Benefit of bail-out vs. cost of intervention; spill-over effects
- » Importance of HAs to national interests and policies
 - High share of dwellings (18%) are socially-rented
 - Around 2 million people on waiting list



Ongoing support v extraordinary support

Ongoing support counted in institutional factors:

- » Normal appropriations
- » Early financial or governance interventions
- » One-off appropriations
 - HCA grant to convert to intermediate rent and market rent
 - Additional grant that could benefit revised business plans of merged entities

Extraordinary support:

- » Default is imminent
- » 'Normal' process not sufficient to correct imbalances
- » Covenant violations likely or already occurred
- » West Hampstead and Ujima

Review of extraordinary support

May 2013 reassessed support to 'Strong' from 'High'

- » Resulted in one notch downgrade of 29 housing associations
 - No changes to BCA
 - Outlook Stable– longer term risks still seen as manageable

- » Review of support levels driven by
 - Weakening sovereign
 - » UK downgraded to Aa1 stable in February
 - Cosmopolitan Housing Association situation
 - Discussion document on regulatory framework

Review of extraordinary support

- » Cosmopolitan Housing Association - lessons
 - Bail outs generally are affected by other housing associations
 - Length of time to resolve- complexity and lack of transparency on risks
 - How does regulator plan to address governance issues early on

- » Discussion document on regulatory framework - questions and answers
 - How practical to implement suggestions – especially ring fencing?
 - Will it reduce risks in the sector or improve protections to social housing assets?
 - Practical issues on definition of social housing assets
 - Clear signalling that in extreme financial distress social housing assets will be prioritised

Rating distribution following May action

BCA	Final Rating	Count
a2	Aa3	1
a3	A1	13
baa1	A2	5
baa2	A2	9
baa3	A3	1
ba1	Baa3	1

- Reduced uplift to final rating
 - BCAs remain same
 - Increased differentiation of ratings
 - bottom end benefits more from regulatory framework and government support
- Final rating reflects
 - Marginally less certainty for creditors
 - Factors in possible issues with timeliness
 - Unsecured creditors might suffer a lost
 - Challenges for regulator
 - Regulatory framework still credit positive

Moody's rates about GBP14+ billion debt for the UK social housing sector

Moody's covers **two thirds** of assets within the sector

Moody's rated debt by Sub-sovereign Group (Fundamental)

- Secured bond programme
- About GBP5 billion

Moody's rated debt by CMBS Group and Covered Bond (Structured Finance)

- Single-name and pooled transactions
- About GBP6 billion (CMBS) and GBP3 billion (Covered Bond)

Changing environment

1. “Affordable rent”
2. Reduction in capital grants from UK government
3. Welfare reform
4. Changes to regulatory framework

Changing environment

1. “Affordable rent” for new SH tenants

- » Higher flexibility (credit positive)
- » Rise in HB expected to compensate for rent rise (credit positive)
- » Increased returns, greater risks
- » No imminent impact: new tenants and re-lets minor against current tenant base

2. Reduction in Government grants for capex

- » Affordable rent to fund new SH development (credit neutral)
 - Expect interest coverage stronger but higher gearing
- » Alternative source of financing: debt, sales, commercial activities, JV
 - Each brings risks and rewards to credit profile

Changing environment

3. Welfare reform

Universal credit / direct payment to tenant (credit negative)

- Distribution / collection risk to be assessed case-by-case;
- Average “revenue exposure” 30% revenue for rated peer

Benefit cap (credit negative)

- Most severe in London for tenants on large accommodations in expensive areas
- Affordability issue relative “affordable rent” setting

Under-occupation penalty (credit negative)

- Potential downside in relocation costs / loss of revenue
- Increase in rent manageable for tenant / opportunity for market rent

Manageable risk for most of rated housing associations

- Slow burn pressure on HAs

4. Potential Changes to regulatory framework

Introduction of Ring Fencing, Living Wills, and/or Public Value could impact analysis

- Successful implementation could be credit positive
- Effective Ring Fencing may result in differentiation between debt and issuer rating

What do we expect?

Wider rating differentiation expected

- » Strength of governance and management to deal with uncertainty
- » Conservative or aggressive?
- » Key movers:
 - Tenant base
 - » Exposure to tenant ability-to-pay
 - » Risk from higher arrears / bad debt; voids
 - » Governance structure to support rent collection and recovery
 - Stock strategy
 - » Affordable rent changes risk balance for operations
 - » Disposals of non-strategic assets
 - » Change in tenure
 - Investment and debt management
 - » Funding for new SH development (affordable rent)
 - » Riskier sources of funding

Moody's publications

Rating methodologies:

- » Rating methodology: English Housing Associations, September 2010
- » Government Related Issuers: methodology update, July 2010
- » The Application of Joint Default Analysis to Government Related Issuers, April 2005

Comments:

- » English housing associations: Direct payment of benefit to tenants a manageable risk, May 2012
- » English Housing Associations: Lingering Downside Risks Despite Positive 2012 Results, December 2012 (147746)
- » Key Drivers of Moody's Actions on UK Sub-Sovereign Ratings , February 2013 (150518)
- » Key Drivers of Moody's Downgrade of English Housing Associations, May 17 (153916)

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Appendix

Moody's public ratings: Aa3

Housing Association	Rating	BCA	Outlook
Affinity Sutton Group Ltd	Aa3	a2	stable

Moody's public ratings: A1

Housing Association	Rating	BCA	Outlook
Devon and Cornwall Housing Association	A1	a3	stable
Family Mosaic	A1	a3	stable
Hanover Housing Association	A1	a3	stable
Hyde Group	A1	a3	stable
L&Q Group	A1	a3	stable
Midland Heart	A1	a3	stable
Moat Homes	A1	a3	stable
Peabody Trust	A1	a3	stable
Radian Group Limited	A1	a3	stable
Raglan Housing Association Limited	A1	a3	stable
Riverside Group	A1	a3	stable
Sanctuary Housing Association	A1	a3	stable
Sovereign Housing Association	A1	a3	stable

Moody's public ratings: A2

Housing Association	Rating	BCA	Outlook
AmicusHorizon Limited	A2	baa1	stable
Circle	A2	baa1	stable
Notting Hill Housing Group	A2	baa1	stable
Saxon Weald Homes Ltd	A2	baa1	stable
Together Housing Group	A2	baa1	stable
East Thames Group limited	A2	baa2	stable
Genesis Housing Association	A2	baa2	stable
Great Places Housing Group	A2	baa2	stable
Hastoe Housing Association	A2	baa2	stable
Longhurst Group Ltd	A2	baa2	stable
Newlon Housing Trust	A2	baa2	stable
Places for People Homes Limited	A2	baa2	stable
Saffron Housing Trust	A2	baa2	stable
WM Housing Group	A2	baa2	stable

Moody's public ratings: A3

Housing Association	Rating	BCA	Outlook
B3 Living Limited	A3	baa3	stable

Moody's public ratings: Baa3

Housing Association	Rating	BCA	Outlook
Assettrust Housing Association Limited	Baa3	ba1	stable

In addition to public rating coverage, ratings and credit estimates (around 40) also assigned privately.