

SECTOR IN-DEPTH

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English Housing Associations

Levelling the Playing Field – Maturing LSVTs match credit strength of traditional HAs

Summary

Within Moody's portfolio of rated Housing Associations (HAs), Large Scale Voluntary Transfer (LSVT) issuers are on an equal footing with their traditional peers in terms of credit quality, defying the common perception that LSVTs are inherently weaker. LSVTs, created through a one-time debt-funded purchase of local authority housing stock, still have some unique credit characteristics. However, their maturing financial profile has brought them more closely into line with traditional HAs, who built up their housing stock with the help of capital grants, and therefore have lower debt. Moody's-rated LSVTs occupy a broad range of rating categories, in a sign that their individual traits transcend their LSVT label.

- » **For the majority of credit drivers, we see no inherent credit distinction between LSVT and traditional HAs in our rated portfolio.** This convergence partly reflects the maturity of Moody's-rated LSVTs. LSVTs' finances typically improve 5-12 years from launch, as they fulfill initial contractual obligations to refurbish their tenants' homes. Across the sector as a whole, most LSVTs have entered or are approaching this mature phase, as 75% of housing transfers took place before 2006.¹
- » **Credit challenges for LSVTs remain, but these are partially mitigated by often overlooked credit positives.** LSVTs' balance sheets are structurally weaker than their traditional peers because their funding history has resulted in a significantly higher level of debt to assets at cost (gearing). We expect the gap between LSVT and traditional gearing to remain near 20% over the next three years. In addition, LSVTs have a lower level of unencumbered assets which restricts borrowing capacity. However, they benefit from some positive credit characteristics which we believe partly mitigate their high levels of debt. These include a low-risk business model, lower arrears, and a higher percentage of fixed-rate debt.

Background on LSVTs

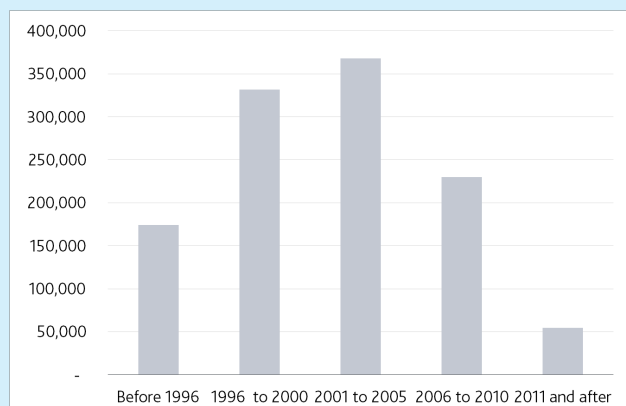
A Large Scale Voluntary Transfer (LSVT) involves a local authority transferring the ownership of its housing stock to an HA with the agreement of tenants. The incentive for the government is to channel private rather than public funds towards improving the quality of social housing stock. LSVTs started in England in the late 1980s, and are still taking place, although they reached a peak in the early 2000s (Exhibit 1). At year end 2013, English HAs managed 1.2 million social housing units transferred from local authorities, equivalent to 44% of the HA sector's total housing stock (Exhibit 2).

Benefits for tenants include improved quality of accommodation, an extension of assured tenancies, and rent guarantees. The HA finances the transfer entirely through private debt, with no capital grant. This results in an initially high level of debt, and often, several years of deficit. However, as LSVTs discharge their contractual obligation to refurbish their housing stock, normally between five and twelve years from the transfer date, they enter a 'mature' phase. At this point they start to report surpluses, and most of their financial metrics improve gradually to levels in line with their traditional counterparts. Most of Moody's-rated HAs are 'mature' LSVTs.

Exhibit 1

Stock transfers are declining

Number of social housing units transferred within given period

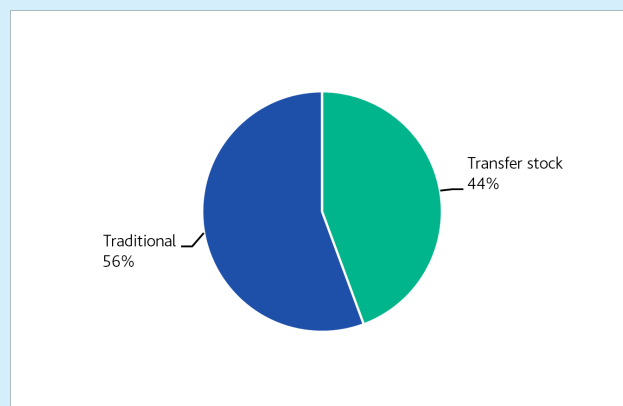


Source: 2013 global accounts of housing providers, Homes and Communities Agency, March 2014

Exhibit 2

The majority of HA housing stock is traditional

Percentage of social housing stock owned by housing associations by type, 2013



Source: 2013 global accounts of housing providers, Homes and Communities Agency, March 2014

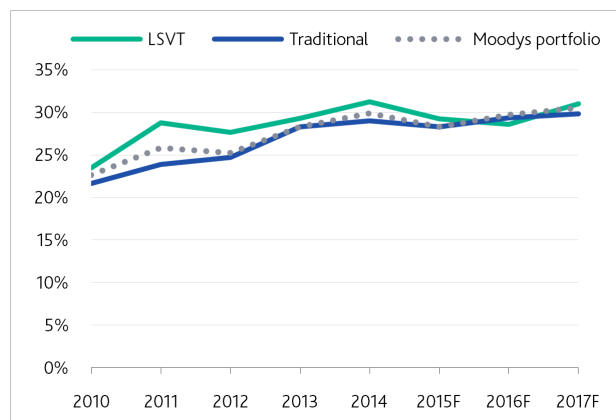
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For the majority of credit drivers, we see no inherent credit distinction based on type within our rated portfolio

Margins will remain strong across the rated portfolio

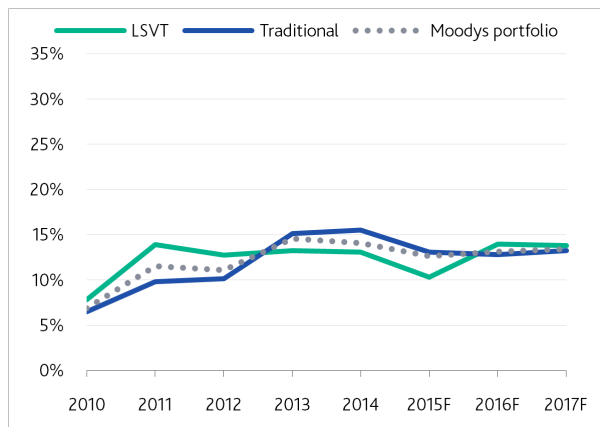
The financial performance of Moody's portfolio of mature LSVTs equals that of their traditional counterparts for most key metrics, a trend we expect to continue. LSVTs are as efficient as traditional HAs, with operating margins for both expected to remain strong at around 30% over the next few years (Exhibit 3). Total margins have also strengthened for both types, and will remain at levels near 13% going forward (Exhibit 4). Management focus on efficiency and the consequent improvement in margins over the last five years is consistent across the rated portfolio, and remains a strength for the sector.

Exhibit 3
Operating margin (median), 2010-2017



Source: Issuers' data for historical performance; Moody's estimates for forecasts

Exhibit 4
Total margin (median)*, 2010-2017

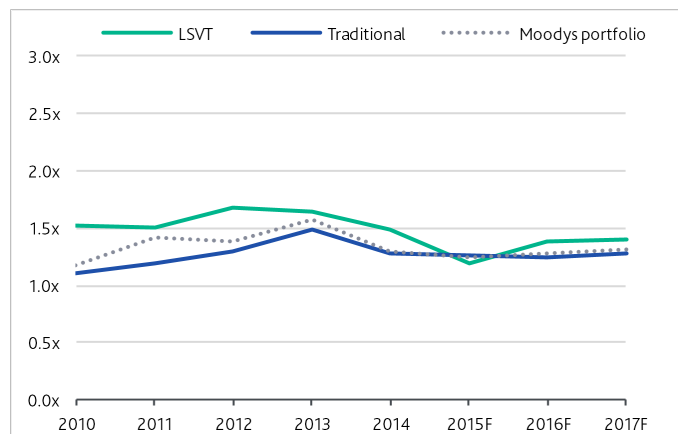


* excluding breakage costs
Source: Issuers' data for historical performance; Moody's estimates for forecasts

Interest cover ratios have converged and will remain aligned

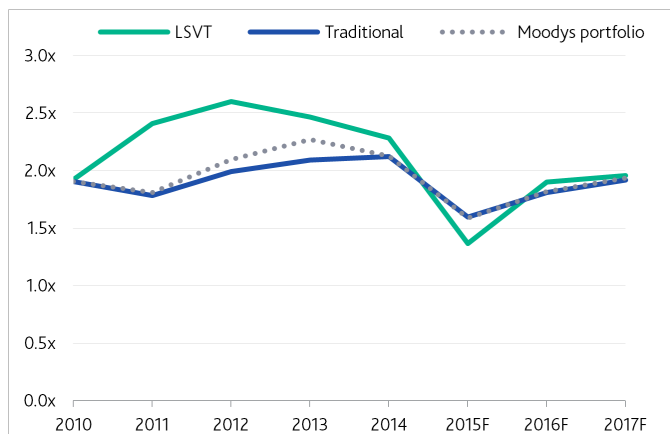
LSVTs' historically strong interest coverage ratios have moderated and fallen into line with rated peer medians (Exhibits 5 and 6), driven by increases in LSVT interest expense. Most rated LSVTs have issued bonds in order to repay legacy bank loans and to obtain capital for development of new social housing units. This debt restructure typically results in higher overall debt levels, and consequently higher debt servicing costs.

Exhibit 5
Social housing lettings interest cover (median), 2010-2017



Source: Issuers' data for historical data; Moody's estimates for forecasts

Exhibit 6
Cash interest cover (median), 2010-2017



Source: Issuers' data for historical data; Moody's estimates for forecasts

Short-term liquidity is strong for both types, similar cost of debt

Short-term liquidity remains strong across the rated portfolio, with half of its constituents holding sufficient cash and immediately available funds to cover at least two years' cash requirements.² LSVTs' short-term liquidity positions are broadly in line with those of their traditional peers (Exhibit 7), despite having a lower exposure to sales and interest rate risk.

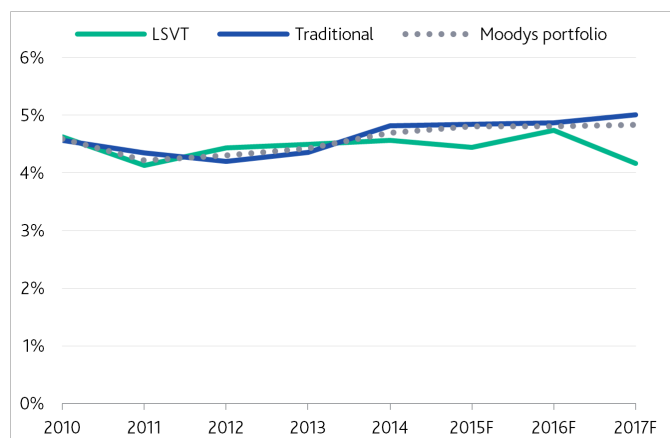
Across the rated sector, HAs utilise both cash and secured loan facilities for sources of short-term liquidity. LSVTs' cost of debt is also in line with that of its traditional peers. Effective interest rates will remain consistent across the portfolio, with medians of between 4% and 5% irrespective of type (Exhibit 8).

Exhibit 7
Cash and immediately available facilities as percentage of turnover, most recently available data



Source: Issuers' most recently reported information

Exhibit 8
Effective interest rate (median), 2010-2017

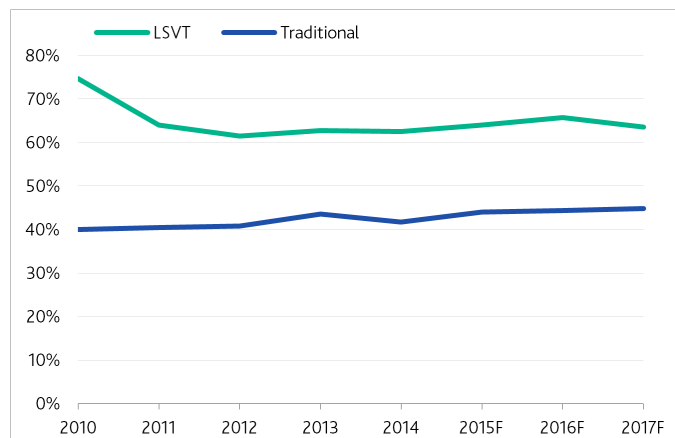


Source: Issuers' data for historical data; Moody's estimates for forecasts

Credit challenges for LSVTs remain as a result of their initial funding structure

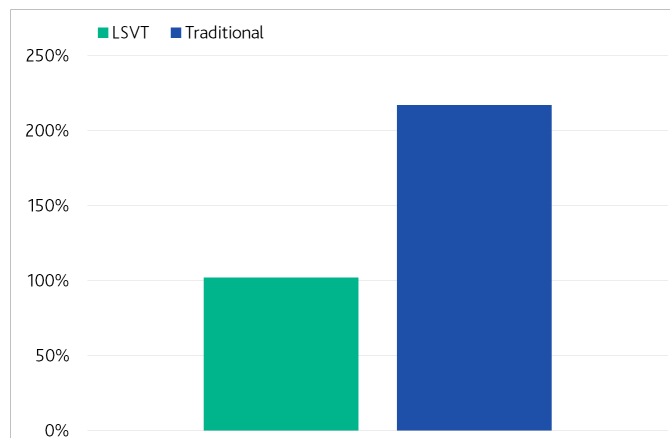
LSVTs' balance sheets are structurally weaker than their traditional peers' because of their funding history. LSVTs financed their initial purchase of local authority housing assets entirely through borrowing, putting them at a financial disadvantage to their traditional counterparts, who benefited from significant capital grants while building up their housing portfolio. We expect the gap between LSVT and traditional gearing to remain near 20% over the next three years (Exhibit 9).

Exhibit 9
Gearing will remain significantly higher for LSVTs Gearing (median), 2010-2017



Source: Issuers' data for historical data; Moody's estimates for forecasts

Exhibit 10
LSVTs have a much lower level of unencumbered assets Borrowing value of unencumbered assets as a percentage of turnover



Source: Issuers' most recently reported information

LSVTs also have more restricted long term borrowing capacity because the high percentage of assets secured to fund their initial purchase of housing stock resulted in very low levels of unencumbered assets (Exhibit 10). Their ability to borrow is further constrained by limitations under the Housing Act 1988 which restrict the valuation of the housing assets they provide as loan security. Housing stock transferred from local authorities is currently limited to Existing Use Value - Social Housing (EUV-SH), equivalent to approximately 30% of market value, rather than the higher measure of Market Value subject to Tenancy (MV-T), or approximately 60% of market value.

In December 2014, the UK government announced that they will be conducting a review on lifting valuation restrictions for LSVTs to allow the higher MV-T value. A consultation is to follow.³

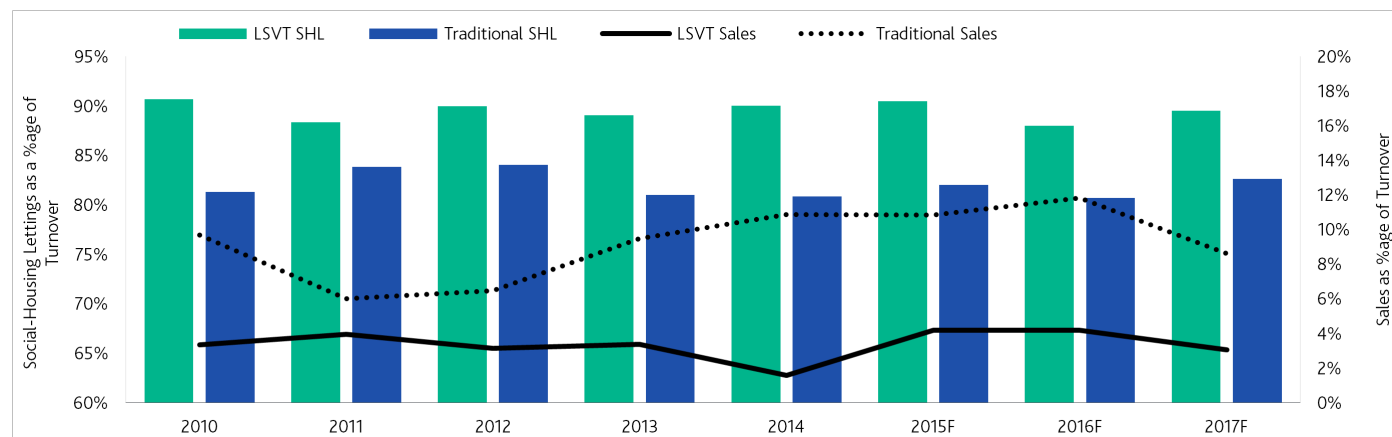
LSVTs' often overlooked strengths counterbalance their weaknesses

LSVTs share a number of credit positive characteristics that partly offset their credit weaknesses. These include a lower-risk business model relative to that of their traditional peers. While many traditional HAs are increasing the proportion of revenues they generate from property sales, we expect LSVTs to maintain a low (<5% of turnover) level of exposure to sales (Exhibit 11), thereby limiting the risks to their business from the cyclical nature of the property market. LSVTs also generate a higher percentage of turnover from social housing lettings, increasing the stability and predictability of their cash flows.

Exhibit 11

LSVTs will maintain their focus on the core social housing business

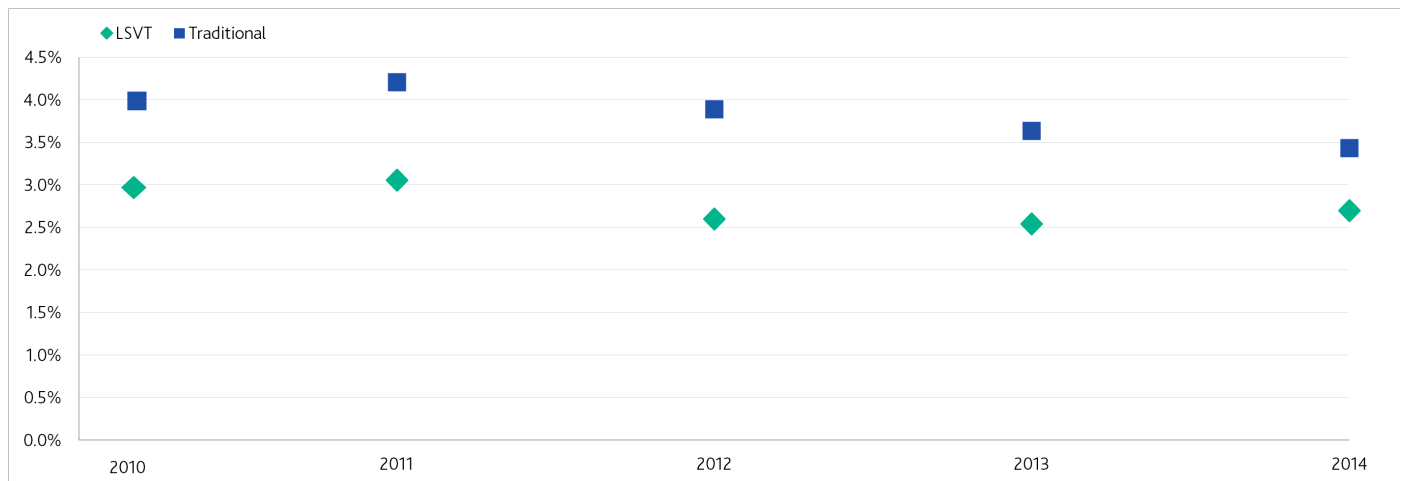
Percentage of turnover from social housing lettings and sales (median), 2010-2017



Source: Issuers' data for historical data; Moody's estimates for forecasts

LSVTs also have over the last five years had lower rent arrears on social housing lettings than their traditional peers (Exhibit 12). LSVTs had median arrears of 2.7% of gross rental income from social housing lettings in 2014 compared to 3.4% for traditional HAs.

Exhibit 12
LSVTs have a track record of stronger income collection
 Arrears (median), 2010-2014

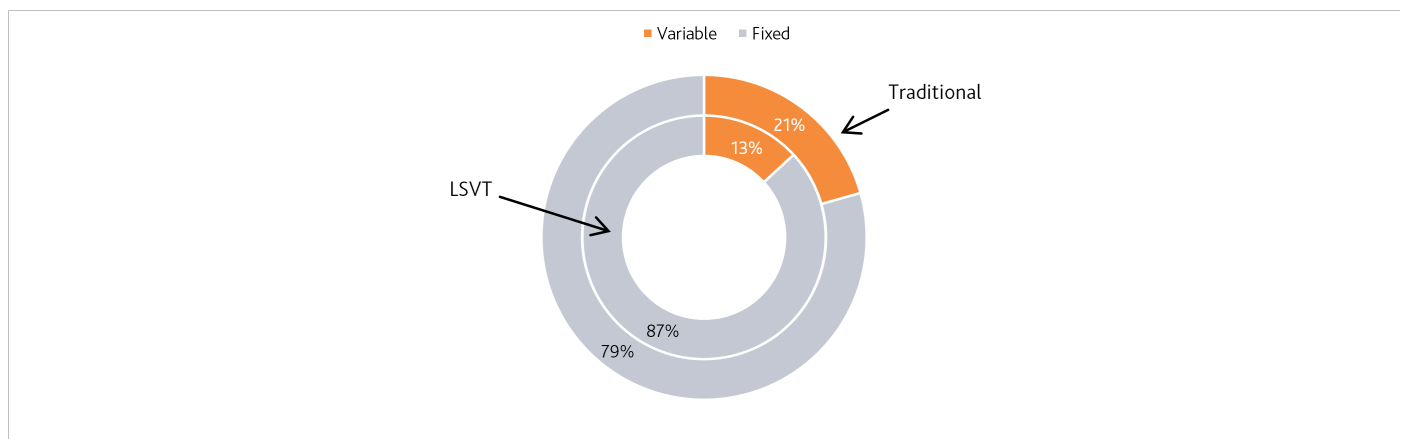


Source: Issuers' data for historical data

Finally, LSVTs have an additional layer of protection against adverse macroeconomic developments thanks to their relatively lower level of variable-rate debt. On average, just 13% of LSVTs' debt was held at variable rates based on most recently available information, compared to 21% for traditional HAS (Exhibit 13).

Many LSVTs have increased the level of fixed rate debt in their portfolios through debt restructuring exercises, with several holding 100% of their debt at fixed rates following bond issuances.

Exhibit 13
LSVTs have lower interest rate exposure
 Debt mix by type (inner circle: LSVT, outer circle: traditional)



Source: Issuers' most recently reported information

Moody's ratings for LSVTs span three categories

LSVTs in Moody's portfolio span three rating categories ranging from A1 to A3, in a sign that intrinsic differences in their credit quality outweigh their LSVT label. Fourteen of our 41 publicly-rated HAs are LSVTs, equivalent to 34% of the portfolio.

Traditional	BCA	Rating	Outlook	LSVTs	BCA	Rating	Outlook
Affinity Sutton Group Ltd	a2	Aa3	Stable	Devon and Cornwall Housing Association	a3	A1	Positive
Riverside Group	a2	Aa3	Stable	Flagship	a3	A1	Stable
Bromford Housing Group	a2	Aa3	Stable	Circle	baa1	A2	Stable
Family Mosaic	a3	A1	Positive	Together Housing Group	baa1	A2	Stable
The Guinness Partnership Ltd.	a3	A1	Stable	Saxon Weald Homes Ltd	baa1	A2	Stable
Hanover Housing	a3	A1	Stable	Saffron Housing Trust	baa1	A2	Stable
Hyde Group	a3	A1	Stable	Walsall Housing Group Ltd	baa1	A2	Stable
L&Q Group	a3	A1	Stable	Herefordshire Housing Limited	baa1	A2	Stable
Midland Heart	a3	A1	Stable	WM Housing Group	baa2	A2	Stable
Moat	a3	A1	Stable	Chelmer Housing Partnership Limited	baa2	A2	Negative
Radian Group Limited	a3	A1	Stable	Grand Union Housing Group	baa2	A2	Stable
Raglan Housing Association Limited	a3	A1	Stable	Yarlington Housing Group	baa2	A2	Stable
Sanctuary Housing Association	a3	A1	Stable	B3 Living Limited	baa3	A3	Stable
Southern Housing Group	a3	A1	Stable	Poplar HARCA	baa3	A3	Stable
Sovereign Housing Association	a3	A1	Stable				
Yorkshire Housing Limited	baa1	A2	Stable				
Paragon Community Housing Group Ltd	baa1	A2	Stable				
AmicusHorizon Limited	baa1	A2	Stable				
Peabody Trust	baa1	A2	Stable				
Notting Hill Housing Group	baa1	A2	Stable				
East Thames Group limited	baa2	A2	Stable				
Great Places Housing Group	baa2	A2	Stable				
Hastoe Housing Association	baa2	A2	Stable				
Longhurst Group Ltd	baa2	A2	Stable				
PfP Group	baa2	A2	Stable				
Newlon Housing Trust	baa2	A2	Stable				
Genesis Housing Association	baa2	A2	Stable				

Moody's Related Research

Sector Comment:

- » [English Housing Associations: Proposed New Regulatory Framework Keeps Pace with Sector Risks, a Credit Positive, February 2015 \(1002469\)](#)
- » [English Housing Associations: Unexpectedly low inflation limits future rent increases and erodes margins, a credit negative, December 2014 \(1001357\)](#)
- » [English Housing Association's Liquidity Trouble Is Credit Negative for the Sector, October 2014 \(176343\)](#)
- » [English Housing Associations: Welfare reform still a credit risk despite early resilience , September 2014 \(175125\)](#)
- » [English Housing Associations: Financial Disintermediation - A One Way Trip, July 2014 \(173505\)](#)
- » [English Housing Associations: Implementation of "Lessons Learned" from Cosmopolitan Would Be Credit Positive, June 2014 \(172097\)](#)
- » [English Housing Associations: Mergers Promise Credit Gains, but Execution is Risky, March 2014 \(165825\)](#)
- » [FAQ: Variable Rate Debt and Swaps in English Housing Associations, May 2014 \(170744\)](#)
- » [All that glitters is not gold - English Housing Associations and Outright Market Sales, May 2014 \(170865\)](#)

Market Outlook:

- » [2015 Outlook English Housing Associations, December 2014 \(177979\)](#)
- » [English Housing Associations in FY2013: Resilient Results In A Challenging Operating Environment, February 2014 \(165197\)](#)

Rating Methodology

- » [English Housing Associations, October 2013 \(156878\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

- 1 Source: 2013 Global Accounts of Housing Providers, Homes and Communities Agency, March 2014
- 2 Please see report "[2015 Outlook: English Housing Associations](#)" on Moodys.com
- 3 In December 2014 as part of the Chancellor's Autumn Statement, the UK government announced plans to consult on lifting the restrictions on valuation of transfer stock

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