RESEARCH:

HOUSING ASSOCIATIONS: RISING DEBT AND DECARBONISING OF THE UK ECONOMY

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KEY CONSIDERATIONS

- ✓ Housing Associations (HAs) are currently facing many challenges including cost pressures, such as increasing repair and maintenance, resulting in decreasing margins, and in increasing debt. ARC expects that debt levels will increase further due to the cash available being insufficient to fund new builds, implement new safety measures, accommodate increasing maintenance charges, and to meet the expected investment required to reduce carbon emissions.

- ✓ The UK government's current goal in respect of carbon emissions is to become net-zero by 2050 and HAs play an important role in this reduction considering the emissions from 2.7m[1] homes owned by HAs contributed c.2.0% of the total 2020 UK's carbon emissions. According to the Regulator of Social Housing (RSH), achieving carbon neutrality for all housing association (HA) homes will be equivalent to the average annual use of 1.8m cars.

- ✓ Sustainable financing for HAs will gain momentum in the coming years. The industry as a whole already has a small number of sustainability-linked loans which provide lower margins and access to additional funding for new builds and investment in decarbonisation of the economy. Sustainable financing is a 'win-win' situation for all, it will demonstrate ESG credentials to investors and could allow HAs to have access to cheaper funding and contributing to a sustainable economy.

[1] National Housing Federation (NHF) Website https://www.housing.org.uk/about-us/

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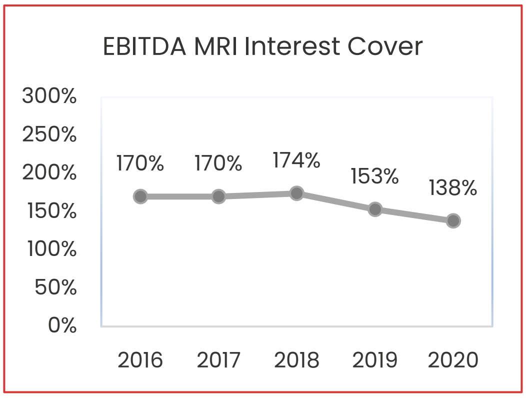
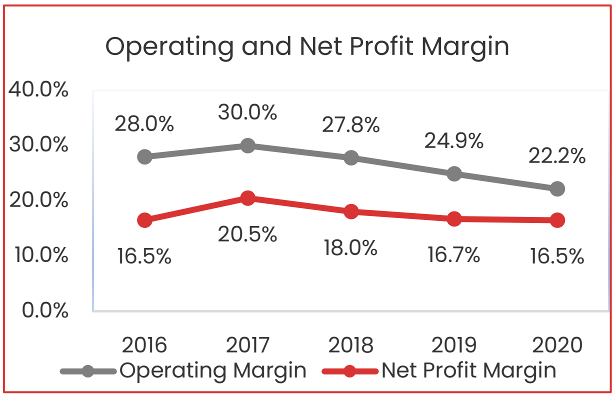
I. RISING DEBT AND FINANCIAL PRESSURE

HAs were reclassified as public sector bodies by official statisticians in 2016, adding £60bn to government debt, an overall increase of 4%. Based on the 2020 Global Accounts published by the RSH, the consolidated debt for HAs reached £83.1bn in 2020, a net increase of 8% from 2019. The sector remains committed to building new homes and raised an additional £10.4bn of new debt in 2020 from banks and capital markets, where bank loans remain the primary funding source.

ARC expects that sector debt levels will reach c.£120bn by 2025 (based on the most recent three-year average debt increase) mainly considering that HAs need to build 340,000 new homes in England alone by 2031 the expected increase in demand.

With the increasing debt, interest expenses will rise, even without expected interest rate increases, putting additional pressure on the EBITDA MRI (maintenance and repairs included) Interest Cover, which is already showing a decreasing trend, consequently reducing net profit margins (refer to charts below).





Source: 2020 Global Accounts published by RSH

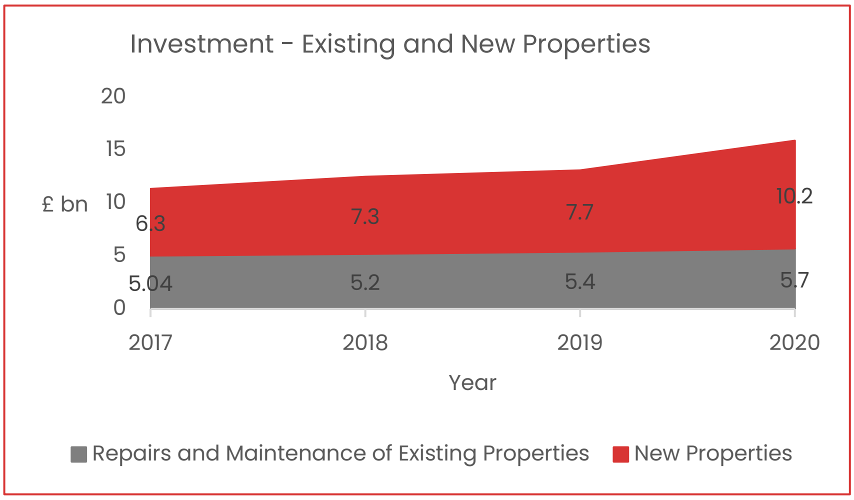
ARC has observed that operating margins were reduced by two main factors:

- The announcement by the UK government in April 2016 that social and affordable rent levels were to be subject to a reduction of 1% each year for four years (2020 was the final year).
- High repair and maintenance costs which are increasing year-on-year as HAs need to maintain their existing stock as well as implement safety measures to avoid a repeat of the Grenfell Tower disaster of June 2017. The number of complaints[2] related to maintenance issues by residents of HAs has increased by 49% between January and March 2021 alone.

[2] NHF https://www.housing.org.uk/about-us/

HAs spent £5.7bn in 2020 (up from £5.4bn in 2019) in repairs and maintenance; ARC expects that the additional recommended safety measures approved in the Building Safety Bill (BSB) in July 2021 will increase this cost, resulting in further reductions in margins.

Despite high repair and maintenance costs and reduced cash generation, HAs are continuing their investment in new homes year-on-year in order to alleviate the housing crisis. As reflected in the chart below, c.£10.2 bn was spent on building new properties, an increase of 61.9% in the 2017-20 period.



Source: 2020 Global Accounts published by RSH

HAs need to be vigilant in maintaining their margins as the new investments and additional safety expenses could lead to a scenario of significant cash expenditures, especially when the £5bn safety fund (set up by The BSB in July 2021) will not be available for HAs which will have to bear their own costs. Note that HA operations were also hit by the COVID pandemic that hindered the progress on new builds and reduced rental income expected from the new builds.

II. HOUSING ASSOCIATIONS AND DECARBONISATION OF THE UK ECONOMY

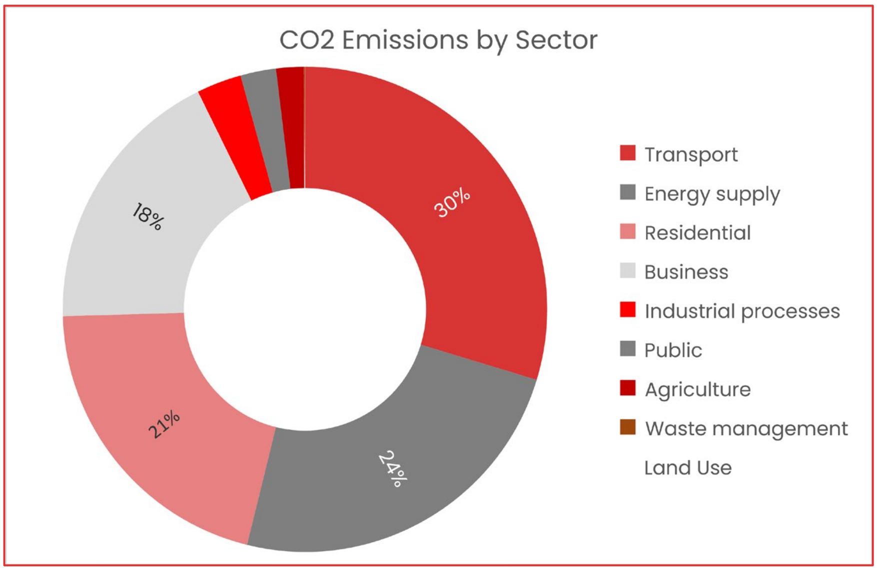
HAs play an important role in decarbonising as homes in England alone produce more carbon emissions every year than is produced by all the country's cars as per National Housing Federation (NHF). In England alone, HAs own and manage 2.7m homes which emitted more than 2% of carbon emissions of the total 326.1MtCO_2[3] (Million tonnes carbon dioxide) in 2020. Without any alleviating action, carbon emissions are likely to increase considering the need of more homes in the next few years.

The UK government has published revised targets for the net-zero carbon emission target by 2050 which includes:

- the acceleration of emission reduction targets to 78% by 2035 (compared to 1990 levels),
- banning gas boilers in new homes by 2025, and
- rolling out Wave 1 of the Social Housing Decarbonisation Fund (SHDF).

The carbon emission from HA homes seems low when compared to total emissions, however, making HA homes more energy efficient will also reduce indirect emissions in housing from the energy sector, for example, the emissions produced in the process of producing electricity which powers heating systems.

Achieving carbon neutrality for all HA homes would be equivalent to taking 1.8m cars off the road indefinitely. The residential sector was the third-largest carbon emitter with a 21% contribution, following the energy supply sector.



[3] Department for Business, Energy, and Industrial Strategy (BEIS)

Carbon leak is one of the reasons for high emissions from the residential sector and is due to poor insulation of homes and gas central heating which force people to use more energy to warm up their houses. In ARC's opinion, improving the energy efficiency of existing homes is essential and should be prioritized to meet the government's current net-zero target by 2050.

HAs plan to invest £70bn in the fabric (insulation), and heating systems of their existing homes. According to research completed by Savills in association with NHF, additional funding of £36bn (base case scenario) will be required to decarbonise all HA homes. Clearly, HAs need funds in addition to their existing cash generation to accommodate costs related to decarbonisation along with building new homes and increasing repairs and maintenance. The sector needs to work closely with the government and industry to deliver these targets over the next three decades.

The Department for Business, Energy, and Industrial Strategy (BEIS), which set up SHDF in October 2020, confirmed that HAs will be able to apply directly for the funding considering their crucial role in meeting the net-zero targets. The government's commitment of £3.8bn (over 10 years) to the SHDF will be a massive help in achieving these goals and £62m of this funding was awarded to 17 local authorities as of March 2021, through SHDF demonstrator to test innovative approaches at retrofitting. Finally, the Wave 1 of £160m of the total fund was initiated in August 2021 for the financial year 2021/22, delivering projects up to January 2023.

III. SUSTAINABLE FINANCING FOR HOUSING ASSOCIATIONS

The availability of sustainable financing is good news for the sector in light of the additional funding required. However, it is important for investors that so-called sustainability loans are connected to environmental targets. Investors will need to track the use of funding and eventually request proof about how it has been utilized to reduce greenhouse gas emissions from energy consumption.

As noted in ARC's recently published research report – ESG Bonds, a growing debt market paving the way for sustainable investments https://arcratings.com/researches/esg-bonds-a-growing-debt-market-paving-the-way-for-sustainable-investments/, ESG labelled bonds are a growing segment in global capital markets with green bonds having the largest share representing 63% of the total USD1.7Tr market in 2020.

Data as of YE20	Green	Sustainable	Social
Total Size of the Market	USD 1.1Tr	USD 317Bn	USD 316Bn
Number of Issuers	1,428	178	601
Number of Instruments	7,716	885	123
Countries	71	30	36
Currencies	42	33	25

Sustainable financing, in the form of sustainability-linked loans (SLL) and green bonds, can provide a new stream of funding at lower interest rates for the HA sector. However, margins will be linked to certain ESG related parameters which should be agreed between borrowers and investors. Investors have started supporting sustainability-linked loans to the HA sector and most of the G15 (an organisation of the top 15 largest HAs) members have been proactive in taking steps towards more sustainable operations.

Recent sustainability linked transactions and developments are noted below:

- BNP Paribas is one of the investors to extend its support for decarbonising the sector and they granted a £50m[4] sustainability-linked loan to the UK's largest HA – Metropolitan Thames Valley (MTVH) in 2020. Another transaction was related to Optivo, where BNP granted a 5-year £50m[4] revolving credit facility which was structured as a sustainability-linked loan, however, in our opinion, it had similarities to a social bond as interest rates were tied to a percentage of the employed residents of the association.
- Bromford, one of the largest HAs in the UK, launched a 'Sustainable Finance Framework' for the year 2021 in accordance with International Capital Markets Association (ICMA)

[4] BNP Paribas Website https://www.bnpparibas.co.uk/en/

and Loan Market Association (LMA). The framework will align to the fixed targets promoted by ICMA such as the use of proceeds, the process for project evaluation, management of proceeds and reporting.

- Bromford NatWest transaction (2019), is one of the examples of a green bond which had a downward margin ratchet linked to the pre-defined targets related to the energy efficiency of its existing homes. The transaction amount was £100m[5] with a 20-year maturity and an all-in coupon of 3.01%.

- Catalyst Housing launched a Sustainable Finance Framework[6] to attract investors and have a new funding source for sustainable projects. The funding can be utilized for new homes and maintenance of the existing stock as these will fall under the sustainable goals. Also, it is worth mentioning that the existing investors such as Barclays and NatWest Markets acted as advisors for the new framework.

With SLL, and social and green bonds, HAs can benefit from lower interest rates compared to traditional funding and the financing can be used for energy-efficient new homes. Some of the recent transactions in the sector show that investors are keen to buy sustainable financing assets to diversify their portfolios and to target ESG labels, therefore ARC expect that the market will allocate capital to HAs for doing social good.

ARC believes that sustainable financing will allow to mitigate two major challenges of the HA sector. The first, providing additional funding to be used to build new homes as well as retrofitting of existing homes. The second, lowering interest expenses permitting the sector to maintain the EBITDA MRI Interest Cover, thus enabling it to generate sufficient cash flow. Even though the percentage of sustainability-linked loans is low as compared to the billions of existing debts of HAs, it still shows a new trend and a step closer towards a sustainable economy.

[5] Bromford Website https://www.bromford.co.uk/

[6] Catalyst Housing Website https://www.chg.org.uk/

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