

Social Housing Report

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BridgECourt & Company
29 Farm Street
London W1J 5RL

Telephone:
+44 (0)20 7347 7700

Fax:
+44 (0)20 7347 7701

Web:
www.bridgECourtandco.com

Author:
Robert Robinson
robert.robinson@bridgECourtandco.com

Pricing Considerations for RSL Bond Issues - A New Financial Landscape?

The recent issuance by Affinity Sutton and Circle Anglia of new secured social housing bonds may represent an important turning point in the funding of RSLs. The new bonds have come at a time when traditional sources of bank finance are shrinking and, where it is available, is increasingly more expensive. Bond finance represents a diversification of sources of funding, but the pricing benefit compared to bank finance is difficult to assess and where it exists may be quite marginal. As well as comparing price and availability between bank and bond finance, it is also worth considering the pricing differences between the Affinity Sutton and Circle Anglia bond issues.

RSL finance directors and treasurers concerned about securing funding over the medium and longer term may need to look increasingly towards the bond market as an alternative source of finance. That said, bond issuance is currently a buyers market and it is expected that increasing issuance from strongly rated corporate entities and sovereign states in 2009 will increase competition amongst issuers. With this in mind, in order to get the best funding terms it will be important for RSLs to develop relationships with key investors and communicate their strong individual credit story to the market.

“Structured” bonds vs. “Corporate” bonds

Historically the sector has issued a number of bonds that have been bought by investors. These bonds are typically “structured” and are de-linked from the direct credit risk of the RSL. High credit ratings are achieved by over-collateralising the security that underpins the bonds, and by having dedicated cash reserves to allow bondholders time to enforce this security. “Structured” social housing bonds also have amortising profiles that help offset some of the term risk factors, including the risk of not being able to refinance in the future.

The Affinity Sutton and Circle Anglia bonds do not have amortising profiles and rely on a bullet refinancing in thirty years time. The bonds are secured by assets owned by Affinity Sutton and Circle Anglia respectively, which the creditors can take control of in the event that Affinity Sutton or Circle Anglia do not meet obligations under the terms of each bond. Unlike many other social housing bonds, the Affinity Sutton and Circle Anglia bonds are not “structured”, but instead rely on the “corporate” credit rating of each RSL. Affinity Sutton is rated Aa2 and Circle Anglia is rated Aa3. This means that if the credit rating of the RSL changes, then so will the ratings of the bonds. Because the rating of an RSL depends on many factors in addition to the value of its properties, it is possible that over time bonds that are linked to “corporate” rating may be subject to greater rating volatility than if the bonds are “structured” so that investors look through directly to the secured properties and their associated cash flows.

The value of properties can also be potentially volatile, but the required over-collateralization in “structured” ratings specifically mitigates this risk. A key covenant for the Affinity Sutton bond is an asset cover test that requires the value of the assets securing the bonds to be a minimum of 105% (on an EUV (existing use value) basis). This level of asset cover is, however, typically less than the over-collateralisation that would be required for a “structured” RSL bond rated at a similar level. Compared with the Affinity Sutton bond the Circle Anglia bond has a stronger overall covenant package from the point of view of bondholders. In part the covenants reflect the weaker credit standing of the association.

Investors buying “corporate” or “structured” bonds are buying different products albeit both secured by RSL assets, and therefore the pricing of these bonds may be different even if the rating is the same.

Affinity Sutton and Circle Anglia - “Benchmark” bond issues

The Affinity Sutton was the first RSL to issue this new type of bond in the sector, and its price in the market would normally be expected to set a benchmark for similar RSL bond issues in the future. The price of the Affinity Sutton bond itself was set with reference to other RSL bonds that are trading in the market at the time, and would have also been considered against other similarly rated corporate bonds.

Most of the RSL public issue bonds are structured bonds, with an exception being THFC’s bond issues that are linked to the corporate credit rating of THFC. Having said that, the THFC model relies on a level of over collateralisation at the underlying borrower level, and THFC itself provides a buffer between the default of an underlying borrower and THFC creditors (including bondholders) in a similar way that cash reserves in structured RSL bonds provide a buffer between

underlying borrowers and bondholders. THFC bonds and RSL structured bonds are rated similarly and trade at similar prices in the market.

The Affinity Sutton bond priced close to existing structured RSL bond issues rather than to other corporate issues with similar ratings. This may be explained by the fact that bond is well secured and in the event of a default by Affinity Sutton, asset recovery values are expected to be high. The asset intensive nature of social housing businesses together with the strong regulatory framework, gives a high degree of comfort to investors. Furthermore, Affinity Sutton has relatively limited exposure to a downturn in the wider UK property market and has not diversified to any significant degree into non-regulated businesses. The credit strength of Affinity Sutton was also reflected in the relatively light covenant package, which did not include an interest cover or gearing ratio covenant. It is likely that the cost of borrowing would have been more expensive, or the covenants more onerous, for an RSL with a weaker credit profile.

The issue attracted a good deal of interest from fixed income sterling investors, and the bond was over-subscribed. As with all other bonds, the price of the Affinity Sutton bond is based on a combination of the price of a Government bond with a similar maturity (otherwise called the reference gilt) plus a margin, which is the price the market assumes for the particular risks associated with an issue (otherwise called the spread). The coupon (or interest rate) paid by Affinity Sutton was 5.981%, which included a margin of 155 basis points (bps). On the date of pricing, the margin on the Affinity Sutton bond was slightly higher than existing RSL structured bonds, but lower than other similarly rated corporate bonds (where margins were over 200 bps).

The Circle Anglia bond priced several weeks after Affinity Sutton's bond, a period during which there has been considerable financial turmoil in the markets. The coupon paid by Circle Anglia was 7.25%, which included a margin of 270 bps. This price was significantly higher than Affinity Sutton's cost of funding. Although Circle Anglia is perceived as a riskier investment, the rapidly widening spreads affecting all corporate issuance across the market, explain a major part of the pricing differential. This has served to highlight the importance of getting the timing of the date of pricing right, because at a time of market uncertainty the costs of funding can change significantly in a matter of days.

Factors Influencing the Pricing of RSL Bond Finance

Bond pricing reflects market supply and demand conditions and the general interest rate environment at a given point in time. While it may not be possible for individual RSLs to influence wider market conditions and the price of government gilts, it is worth looking at what factors may influence the margin associated with an RSL bond issue.

Investors will typically undertake their own due diligence to identify the risks associated with a particular issue. Public credit ratings provide an independent third party opinion on default risk, and because these opinions are in the public domain, they can help with the initial pricing and the buying and selling of the bonds in the future. Ratings are also important for bond investors as the fund portfolios they manage have rating specifications as outlined by their client's mandate, for example pension funds typically have rating conditions associated with their managed funds. Bond issues usually have at least two credit ratings from different credit rating agencies, but the Affinity Sutton issue and the Circle Anglia issue both only had on a single rating from Moody's.

This may have had minimal influence on the pricing of both issues because investors who tend to buy this type of bond will typically hold it in order to match their own longer term liabilities. There is limited secondary market trading of RSL bonds, and historically there has been little rating volatility in the sector.

The credit rating of the bonds reflects only one element of investors' risk considerations, namely default risk. Other risks not necessarily directly reflected in the rating are also likely to impact on pricing, such as the availability and ability to secure liquidity for future refinancing needs, expected changes in interest rates, term risks, and general market sentiment. A further important consideration in pricing is the ability to trade the bonds. RSL bonds have typically been a much less liquid market than corporate bonds. The absence of a significant secondary RSL bond market suggests that RSL bonds may go into illiquid funds held by investors, and this may to some extent influence pricing.

The Affinity Sutton and Circle Anglia bonds both had terms of 30 years. The bond terms reflects the current demand from institutional investors who seek to match their own longer term liabilities where the certainty of a fixed rate of return is sought. However, despite the strong investor interest in the issues, a large percentage of the bonds are bought by only a few investors who have a strong influence over the pricing of the issue.

If more RSL bonds, including shorter-term bonds, are issued, this may attract more investors to the sector. If a liquid secondary market is able to develop, then pricing may become more favourable for social housing issuers. As the RSL bond market becomes more sophisticated, then so will investment decisions. Investors will focus more on the risks associated with the sector and are more likely to differentiate between RSLs. Many investors are aware that the level of risk within the sector is increasing. Housing stock built for market sale or rent is not selling, and converting these developments for social housing provision does not always necessarily meet the financial costs incurred for some RSLs, resulting in a shortfall. Treasury management strategies are also coming under scrutiny as the cost of borrowing grows and committed but undrawn bank facilities secured when funding was cheap are running out. That said, many investors consider social housing to be a 'defensive' investment in times of economic uncertainty, as less rating and price volatility is expected compared to many other corporate sectors.

Changing Financial Landscape

Bank funding still remains the major source of funding for the sector, but even if LIBOR rates do come down over the next few months, we have seen some fundamental changes to the global banking sector that are likely to rule out a return to cheap available bank finance to RSL's in the near future. Even before the recent turmoil in the financial markets, a number of banks had significant exposures to RSL businesses; mergers between RSLs in recent years have increased the banks' exposure to individual RSL credits. Now the banks are being consolidated, and if this trend continues over the next year or so, there is likely to be a material increase in the lender's total exposure to a particular sector or individual RSL. This, together with the fact that banks need to recapitalise their balance sheets, is likely to mean that bank lending margins will remain relatively high for some time.

Given the continued high level of inter-bank lending costs and the higher margins required by banks in order to rebuild their balance sheets, it remains to be seen whether bond funding will be a competitive option for RSLs over the medium to longer term. Comparing pricing between bank and bond funding is not always that straightforward. The all in costs associated with bank funding are not always necessarily that clear, particularly where costs are linked to additional fees in addition to arranging and commitment fees, such as for hedging arrangements. The flexibility associated with bank funding has also come under scrutiny as banks have been less inclined to waive covenant breaches without improving their returns on lending. The RSL bond market, however, is relatively immature and tends not to be particularly liquid. There has not been any notable investor involvement for several years, and there has been limited bond issuance in the sector. If a more significant market for RSL bond funding does develop, then new investors will be assessing risks associated with RSL borrowers from a fresh perspective. It should not be assumed that these new investors would necessarily mirror the traditional views and assumptions regarding the level of risk in the sector.

It is not just in the banking sector where funding risks have increased, risks in the RSL sector have also grown and in the event that an RSL gets into serious financial trouble, it should not be assumed that the regulator or the Government will always be in a position to come to the rescue - an assumption that has strongly underpinned lending decisions in the sector to date. Following recent Government intervention in the banking sector, and the possibility of further Government bailouts in the banking and other sectors, investors will ask where in the spectrum of “essentiality” to the UK Government does rescuing an RSL lie. The answer in the current context may not be very high. The likelihood of RSL insolvency may therefore not as remote as it was once perceived.

If significant growth in the RSL bond issuance occurs, then bond markets will play an important role in the development ambitions of RSLs. Just as the bond markets play an important role in the financing of other corporate sectors, the changing financial landscape means that RSLs will need to give much greater consideration to securing good credit ratings, developing on-going relationships with investors with an interest in the sector, and understanding the drivers of pricing outcomes in the bond markets.

Although the market for bank and bond finance remains volatile and uncertain, RSLs would be prudent to think ahead and keep as many funding options open as possible in case any avenues are made more difficult to access, or indeed are closed off in the future.

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