MORhomes PLC

MORhomes Borrower Business Plans and Credit Models
Analysis of Aggregated Data – June 2022 Returns
By Patrick Symington, 9 September 2022

Executive Summary

MORhomes has a unique understanding of the UK Housing Association (HA) sector, in part due to its bespoke credit model. This paper provides analysis on the latest financial plans submitted by MORhomes' 20 HA borrowers, based on regulatory returns at June 2022.

Borrowers have had to respond to a dramatically changing economic environment and changing priorities. Overall, the average credit score from the model is stable compared to a year earlier, demonstrating that they have adapted well and maintained their overall financial strength. No individual borrower score moved enough to result in an upgrade or downgrade in their rating level.

Compared to a year ago, more detailed analysis shows

- Interest cover (before major repairs) stable
- An increase in investment in existing stock adversely affecting interest cover including major repairs
- A reduction in the future development programme
- Borrowing controlled to increase broadly in line with inflation and stock value
- Liquidity significantly improved
- Borrowing capacity (based on uncharged stock) significantly improved.

Borrowers are generally planning to achieve an energy performance rating of EPC C by 2030. They have strategies for addressing the Government's target of 'zero carbon' by 2050 but there are still too many unknowns to fully reflect the financial implications of achieving this, which are mainly beyond the current development planning horizon.

The HA sector (and the MORhomes portfolio) remains very strong with inherent resilience to difficult economic conditions. This includes the ability to flex development plans, debt under 50% of stock value (MVST basis), loans secured on property and a large proportion of debt at fixed interest.

There are further challenges ahead, including a recent Government proposal for a rent increase cap in 2023. This will require HAs to revise their financial plans. We expect borrowers to continue to show their flexibility and adaptability in managing their financial strength.

MORhomes has a unique ability to monitor this via its credit model. MORhomes engages with borrowers proactively as part of its ongoing credit monitoring. If there are material changes borrowers are required to provide updated models to MORhomes.

Regarding the demand for new borrowing, MORhomes expects that there will continue to be a demand despite the increasing constraints on HAs. With the changing economic conditions, MORhomes is finding an increasing interest from HAs wanting to borrow smaller amounts more frequently, accessing the market flexibly. MORhomes has an unrivalled ability to meet this demand.

Introduction to MORhomes and background

MORhomes was set up by the Housing Association (HA) sector to enable HAs to get fast and efficient access to the debt capital markets. It only lends to not for profit registered UK HAs and has a unique understanding of the sector.

Part of this understanding is based on its bespoke credit model. Based on rating agency style metrics this model was designed specifically for the HA sector. Features include

- 5 years historic data
- 5 years unpublished forecast data based on regulatory returns
- Weighted average credit score based on 7 key rating metrics
- It monitors the HA business as a whole, and there are no loan covenants on specific metrics, which can artificially restrict HA businesses.

MORhomes has recently received updated business plans and credit models from all its 20 HA borrowing groups (17 in England, 3 in Wales). The financial plans were based on results for 2022 and (for English HAs) forecast data submitted to the regulator (RSH) at the end June 2022.

This report provides some analysis of the data at aggregated level across the 20 HAs.

Note that the RSH itself is not due to comment on the data until the end of October.

<u>Overall Financial Strength of HAs compared to a year ago</u>

This section compares the credit models of the 20 borrowers at June 2022 to their models at June 2021.

The average overall credit score across the sample showed no material change and no individual borrower score moved enough to result in an upgrade or downgrade.

Some of the significant changes between the two years were

- Total forecast capital investment over the years 2023 to 2026 is up from £3.8bn to £5.0bn (32%)
- This is partly the result of the cumulative effect of increased maintenance and construction cost inflation assumptions
- However, another significant driver is increased investment in existing stock. The reasons for this could include fire safety work, an increased priority for good stock condition and the first stages of decarbonizing stock
- Development programmes have been cut back, with forecast units owned by 2026 down 2% with construction cost inflation offsetting the reduction in units
- However, whilst capital expenditure increased by £1.2bn, the majority of this has been funded internally, with borrowing only increased by £0.5bn, resulting in debt by 2026 being only 6% higher
- An increase in available borrowing facilities, which is a prudent response to future uncertainty, with HAs taking advantage of very low interest rates during the year
- The percentage of uncharged stock (available to secure future loans) increased as borrowers brought new stock on stream and improved their security efficiency
- The impact of increasing interest rates was limited due to the high percentage of fixed rate debt held by HAs.

The effect on some of the key credit metrics was as follows

- Interest cover (based on social housing income before major repairs) was unchanged
- However, interest cover after adjusting to include major repairs was weaker due to increased investment in stock
- Net debt per unit by 2026 was up by 8%, which is broadly in line with increased inflation over the period
- This is borne out by the net debt to earnings ratio which was unchanged between the 2021 and 2022 plans
- MORhomes loans are secured on stock that is subject to a desktop revaluation each year (either on the EUV-SH or MVT basis). On average the revaluations at March 2022 were 6% higher than a year earlier
- Liquidity ratios significantly improved
- Borrowing capacity (based on uncharged stock) significantly improved.

With the average overall credit score stable, we believe this demonstrates that borrowers have responded well to the changing environment and priorities whilst maintaining their overall financial strength.

<u>Planning for ‘net zero’ carbon</u>

Most borrowers have included specific provisions for ensuring compliance with the Government’s target for all stock to achieve an energy performance rating of EPC C by 2030. As at March 2022 75% of stock across all borrowers met this standard.

All borrowers have strategies for addressing the Government’s target of ‘net zero’ carbon by 2050. Some have incorporated financial provisions for achieving this, but for most a full net zero plan is not yet incorporated. We believe this is a reasonable approach at present because there is still uncertainty about

- What the exact regulatory requirements will be
- What technical solutions will be required and the cost of these
- How the work will be funded.

Further expenditure is likely to fall in the period 2030-2050 which is generally beyond the horizon of current development programmes where business plans show borrowing reducing and capacity for further investment. The decisions on how to balance priorities in this period have yet to be made.

<u>Strength of sector and MORhomes portfolio</u>

This analysis demonstrates the strength of the HA sector and its resilience to difficult economic conditions. Some key features of the sector (reflected in MORhomes’ portfolio) are

- HAs borrow against the security value and income stream of existing stock to fund new development. This means that generally they can respond to financial stress by reducing development
- Borrowing for future development is subject to the development being viable based on the build costs, grant, rents, interest rates and operating costs projected at the time of commitment. Borrowers can adapt their viability appraisal to changing economic conditions and ensure that as they add in new development to their financial plans, they maintain their financial strength

- The intrinsic value of HA stock is much lower than overall debt. For MORhomes' borrowers, debt is on average only 49% of the estimated value of the stock on the MVST (market value subject to tenancy) basis
- Individual loans are generally secured against stock. In MORhomes' case borrowers have up to 12 months to secure stock, during which period sufficient security must be available to charge. MORhomes' asset cover ratios are a minimum of 105% (EUV-SH) and 115% (MVST) and on average secured loans have 31% excess security value above this. For individual secured borrowers this ranges between 8% and 80% excess security
- A high percentage of loans are fixed interest, with refinancing/ refixing risk spread over up to 30 years. This reduces the exposure to increases in interest rates.

<u>Outlook and impact of recent developments (including rent cap proposals)</u>

The 2022 financial plans analysed above were prepared over the months leading up to the June regulatory deadline.

The Government has recently issued a consultation on proposals to cap rent increases in 2023 to 5%. The current rent increase formula is CPI+1%, based on CPI in September 2022 which is forecast to be around 10%. If implemented, as seems likely, this will require HAs to revise their financial plans.

MORhomes' borrowers had been relatively conservative on rent inflation in 2023, assuming on average an increase of around 7%. They had also assumed maintenance cost increases above CPI over a number of years.

The had all modelled reduced rent scenarios and corrective action to deal with this. We would expect borrowers to now be modelling the implications of the proposed rent cap, looking at development and borrowing plans, maintenance expenditure plans and operating efficiency. We expect borrowers to continue to show their flexibility and adaptability in managing their financial strength.

If there are material changes in their business plans, borrowers are required to provide them to MORhomes once approved by their boards. However, MORhomes will engage with them proactively at a much earlier stage as part of our ongoing credit monitoring.

Regarding the demand for new borrowing, MORhomes expects that there will continue to be a demand despite the increasing constraints on HAs. Debt capital market borrowing by HAs was around £6bn in 2021. Up to August 2022 it was around 25% down on last year and could drop further if HAs cut their development plans. However, we expect the sector to continue to invest in existing and new stock and there is a regular demand for loans to refinance existing facilities. We expect there to be a significant ongoing demand.

With the changing economic conditions, MORhomes is finding an increasing interest from HAs wanting to borrow smaller amounts more frequently, accessing the market flexibly. MORhomes is uniquely structured to meet this demand. We can get all the documentation ready for a new loan from a standing start in as little as 4 weeks. Once documentation is in place, we can be on standby to go to the market and take advantage of favourable conditions. The minimum loan is just £10m.