

# The impact of the credit crunch on housing associations

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# Introduction

## The credit crunch and potential effects on RSLs

Registered social landlords (RSLs) benefited from a prolonged period of favourable economic and financial conditions in the years leading up to 2008, with low inflation and borrowing costs, whilst a rising property market increased demand for both rental and shared ownership properties. So, although some factors have been less favourable, such as building and maintenance cost inflation and falling grant rates, the sector has enjoyed an unprecedented period of growth, not least because of the transfer of stock from local authorities.

Since 2008, the funding market has been severely constrained (the 'credit crunch') and the housing and building markets have contracted substantially. Diversification by RSLs into areas such as build-for-sale and market rent has increased the exposure to market fluctuations though demand for social rented housing is generally counter-cyclical and much of the rental income stream is government-sourced.

While the causes and effects of the credit crunch have been much explored elsewhere, some broad points are useful for providing context to the rest of the study. The 'credit crunch' essentially refers to the dramatic reduction in bank lending beginning in August 2007. Widespread concern as to the quality of assets pledged as collateral against interbank lending provoked the freezing of the interbank market, on which many lenders depend for ongoing liquidity and lending capacity. The concern was

triggered by increasing defaults, particularly of sub-prime mortgages in the US.

Since 2007, economies throughout the world have entered recession, hitting demand, employment and asset prices. Lending has been severely limited and generally expensive when available. Particularly in the US and UK, property and land prices have fallen, and there has been a shortage of mortgage finance. Governments have responded with measures such as re-securitising banks, deficit-financed expansionary fiscal policies and historically low interest rates.

The RSL sector's business model means that it has been well placed to deal with the impact of the recession. Its core rental income stream accounts for 80% of turnover and is around 65% government funded through Housing Benefit, ensuring that it has a greater degree of certainty over its revenue than most commercial businesses. This stability, in addition to government support for capital investment, means the sector has been able to continue growing during the downturn and enables it to undertake valuable projects which would be untenable in the commercial sector.

The demand for social housing is also likely to increase during a difficult economic period, although since there are already substantial waiting lists the effect of this may be marginal. In addition, the debt held at floating rates will have benefited from historically low LIBOR and the depression in the building sector may mean that the price of new stock comes down.

However, the economic conditions also potentially present challenges to the sector. The cost of debt to RSLs is higher than the base rate might suggest and is likely to mean reduced expansion plans, with lenders also taking the opportunity to re-price existing facilities and impose more stringent conditions. Expansion is also limited as less commercial development reduces the amount of property available through s106 deals. The reduced availability of domestic mortgages has also hit demand for shared ownership property, with potential knock-on effects on working capital requirements and the viability of individual schemes. Falling property values will hit land holdings and stock where held at valuation. A substantial part of RSLs' cost base comprises wages, which may prove difficult to reduce to compensate for lost revenue.

This study uses statutory accounts data for a representative sample of RSLs, property companies and a more general group of corporates to explore the effects of the economic downturn and credit crunch across the three peer groups. It then goes on to unpack the impact on the associations in more detail, before concluding on the future for the RSL sector in particular.

# Executive summary

Overall, the RSL sector's trading performance has come through the economic turbulence relatively unscathed. Revenues have continued to grow throughout, and while there have been some falls in margin, these can largely be attributed to factors other than the credit crunch. The key question going forward will be the sustainability of margins if rents remain constrained and costs continue to increase in excess of inflation. While at present the aggregated sector is generating enough cash to service its debt adequately, concerted board and management action will be required to maintain and improve operating margins.

While there has been some weakening of the sector balance sheet in terms of gradually increasing leverage, from around 35% to 39%, and higher debt/surplus ratios, the sector has avoided the worst of the crash in property values and remains relatively lowly geared. This is partly due to holding many assets at cost. There continues to be substantial investment in new assets with the potential for further expansion.

Compared to the wider economy and the property sector in particular, the RSL sector has experienced less instability and maintained steady growth. Where property companies have had to make substantial write-downs to their assets and the margins in the wider economy have been squeezed, the RSL

sector has been largely insulated by high and rising demand, the security of income streams and the flexibility to move property between tenures to maintain cash flow. Asset write-downs in the RSL sector represent around only 0.1% of balance sheet values.

In terms of balance sheet structure, the RSL sector has developed in a similar fashion to the wider economy. Leverage and debt/earnings multiples have increased, which suggests that finance is available for investment if required. The overall picture is that lenders tolerate considerably lower interest cover from RSLs than from other sectors.

The RSL sector is unlikely to generate market-leading returns on investment, due to its low margins, restricted income streams and high capital intensity. However, the same factors that constrain it also give it stability and potential. Provided housing demand remains high, lending rates remain favourable and rents predictable, this analysis demonstrates that the RSL sector's core business offers potential for secure investment and growth when there is turbulence in the wider economy.

# Comparison with other sectors

The RSL sector has several attributes which set it apart from the wider property sector, in particular stable rental streams and favourable interest rates. This lower risk is reflected in lower profitability, but also greater stability in a volatile market. The analysis below employs a range of commonly used metrics to compare the performance of the sector with its commercial peers.

The private property sector (along with financial services) was probably the area of the economy which benefited most from the years of growth prior to 2008. Consequently, it had the furthest to fall in the subsequent downturn, and it might be expected that non-property companies would fare better. However, given the reliance of the wider economy on property-based lending to support income, the

effects of the fall in property values are likely to be seen elsewhere in the economy. While the RSL sector is not immune from these pressures, its counter-cyclical demand structure and favourable funding regime suggest that it may also have outperformed the wider economy in some areas.

This section compares the median levels for various indicators between the RSL sample and the property and non-property groups.

The RSL median achieved growth in turnover well in excess of inflation in all years, and at an increasing rate. The non-property group's turnover fell in real terms in 2008 before rebounding strongly in 2009. The property group is still in a state of decline, which may reflect the long lead times involved in

Figure 1 Growth in turnover %

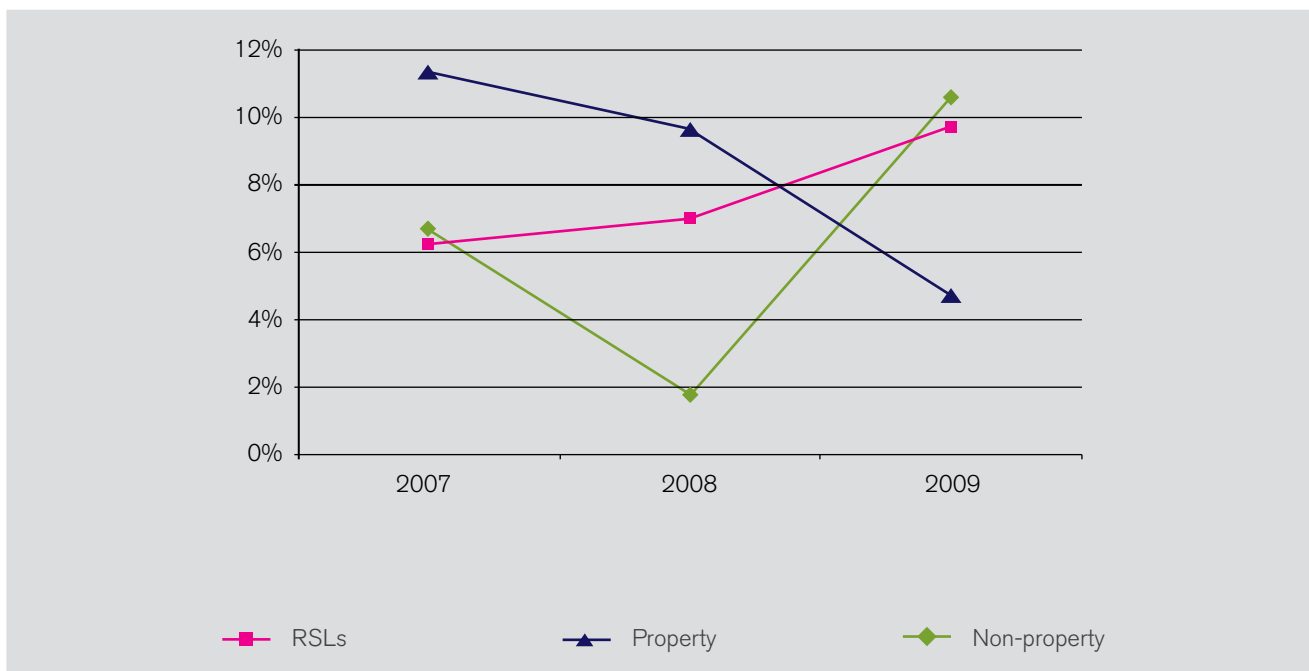
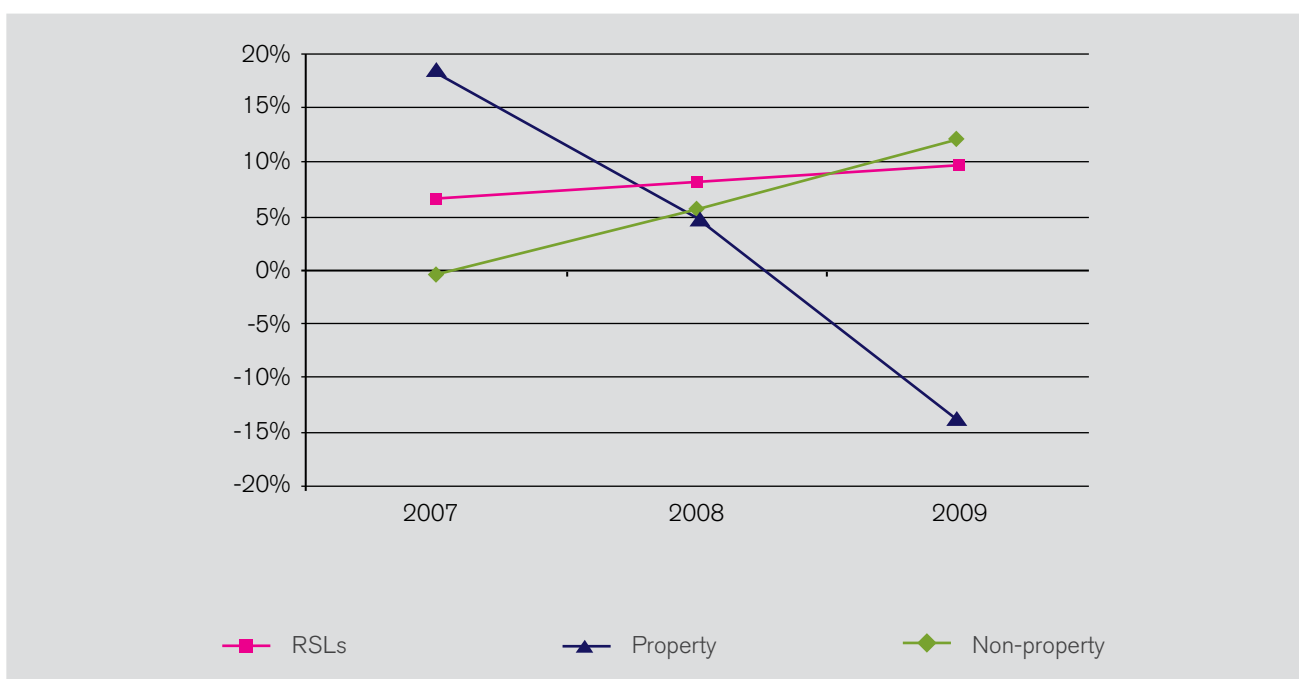


Figure 2 **Growth in total assets %**



developing sites, the low availability of financing and retrenchment elsewhere in the economy.

The relatively greater effect on the property sector is also demonstrated in the rate of asset growth (see figure 2).

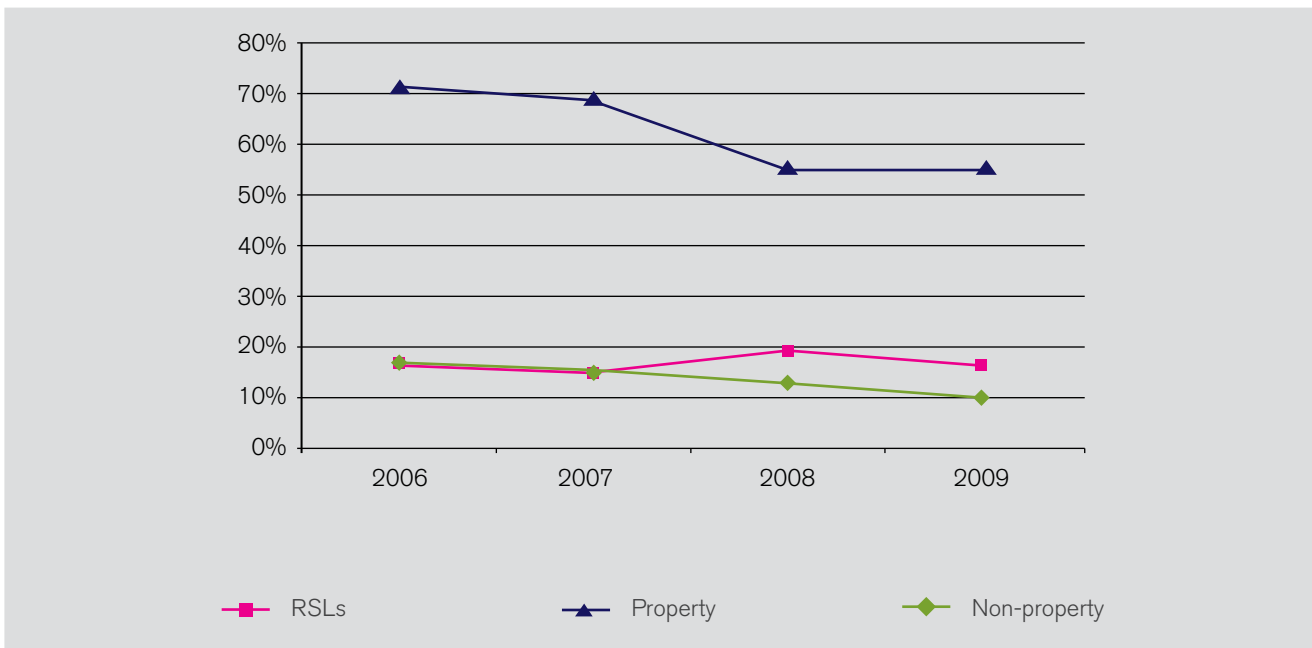
Property companies hold the assets which have proved most over-valued in the current recession – both in terms of resale value and future cash flow, as demand for rented space has declined along with the rest of the economy. Consequently, they have experienced substantial write-downs in asset value between 2008 and 2009. The effect on property asset growth can be seen to lag behind the wider economy, where the rate of asset growth has been increasing since 2008.

RSLs again demonstrate stability and growth throughout the period, despite holding property assets. In part, this is due to having smaller land banks and fewer commercial property holdings, and in part due to continuing high occupancy rates. Accounting treatment may also play a part, with more assets accounted for at cost and less susceptible to impairment.

The particular structure of the property sector compared to the wider economy is well illustrated by its operating margin (see figure 3).

Compared to the wider economy, property companies tend to either make a small number of high value-added transactions (eg refurbishment, site assembly and progression) or generate returns

Figure 3 Operating margin %



on capital investment over a long period of time (eg renting). Both of these activities will tend to be high margin.

Given that most RSL transactions are broadly similar – rentals and property sales – it is perhaps surprising that margins are so much lower. However, the particular nature of RSL property transactions keeps margins low. Social rents are restricted, and in general lower than the market rent for a comparable property. Commercial rents are higher again, with greater risks of over-supply and under-occupancy – a potential explanation for the decline in margins over 2007-08 and 2008-09, assuming most impairment was treated as exceptional. RSLs also tend to offer more expensive services to their tenants, cutting further into margins. Where RSLs benefit from the gain in, for example, obtaining

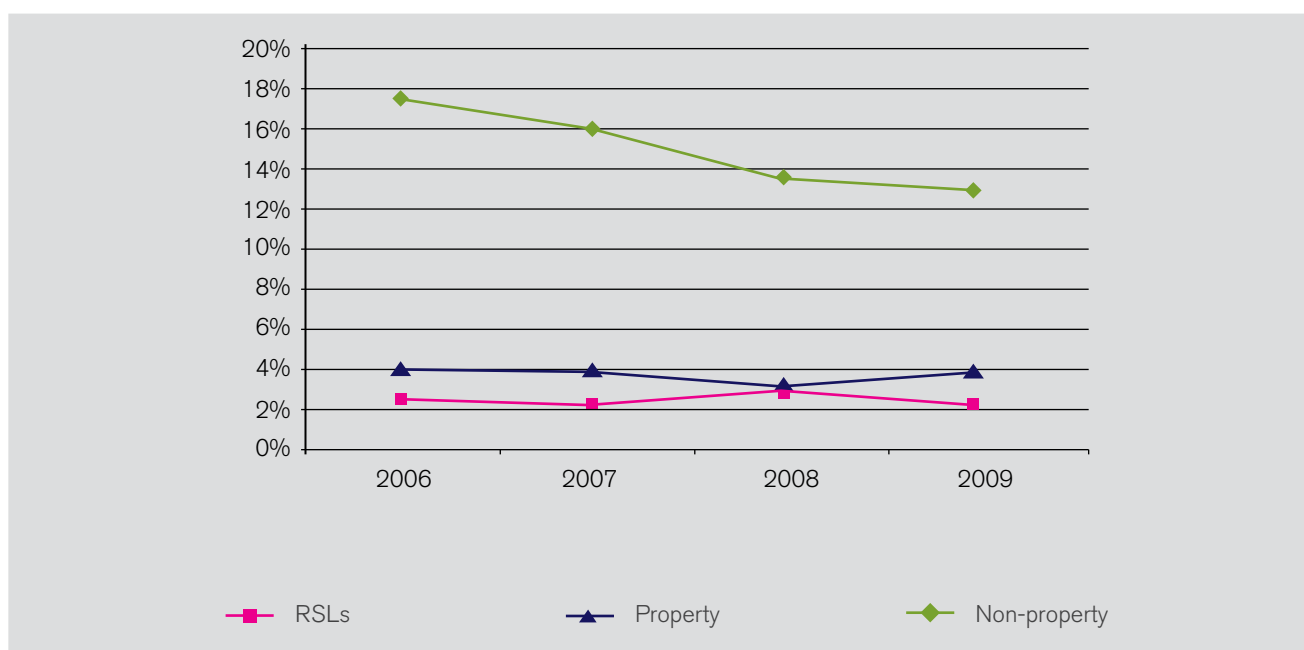
planning permission on land, this is generally a capital rather than a revenue gain.

All of these factors suppress the RSL median margin to a similar level to the median in the wider economy. However, the greater stability in the RSL market has enabled it to outperform the wider economy over the last two years as trading conditions have become more difficult. This suggests that the RSL sector remains a relatively safe investment for generating predictable returns.

The lower risk level is also reflected in the return achieved on assets, in a typical year around half that achieved by property companies (see figure 4).

RSLs show a stable return on assets of between two and three per cent, while the fall in asset values

Figure 4 **SBIT total assets % (EBIT % capital employed)**



in the property sector has generated a higher return. The wider economy has seen a significant fall in the return on assets, in line with the fall in the operating margin.

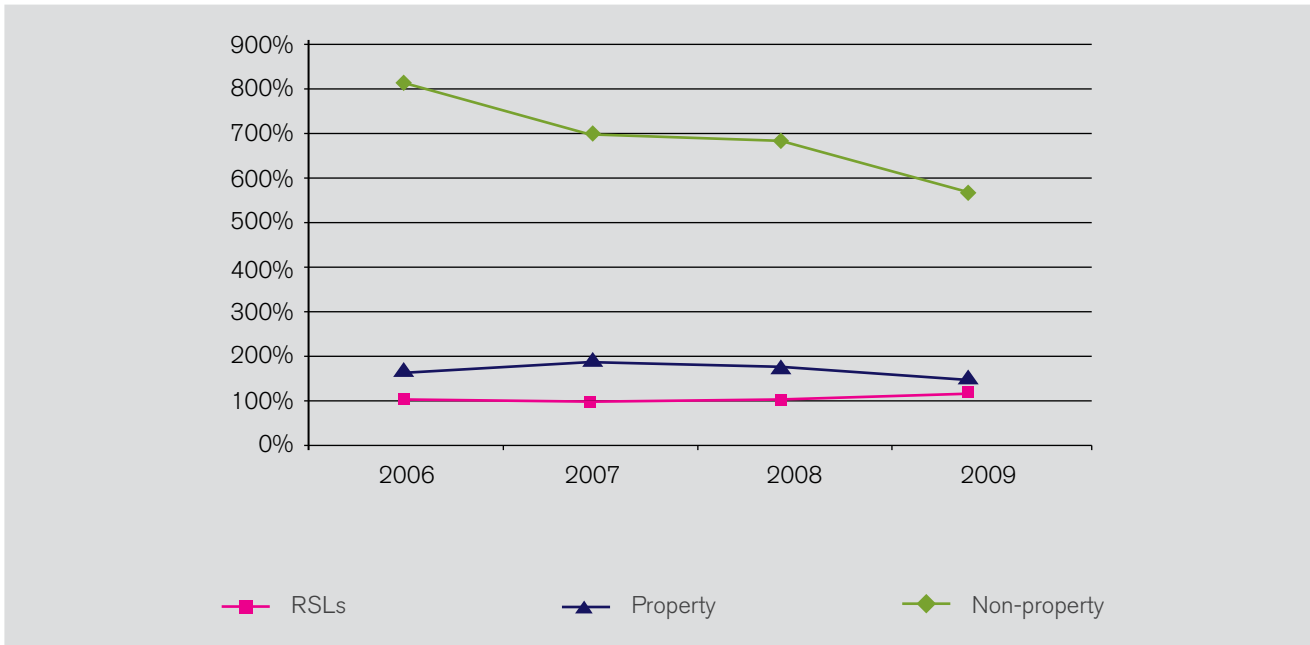
This illustrates the difference in characteristics between RSLs, property companies and the wider economy. Property companies tend to run with high margins, reflecting the risk arising from requiring a high level of capital. The amount of capital required, means that the returns on it are fairly low, despite the high margin. The wider economy is less capital-intensive and thus the same profit would represent a greater return despite lower margins. However, the RSL sector generates a low return with low margins and high capital. This is as a result of several factors: the predictability of much of the income stream through high demand

and government-backed revenues, rent limits and potentially the absence of profit distribution meaning that the same investment can be achieved from less surplus.

As a result of this relative security, lenders are willing to tolerate lower levels of interest cover from RSLs than from the wider property sector (see figure 5).

The greater certainty of income in the RSL sector, means that it is able to operate with a much lower level of interest cover compared to both the property and non-property sectors. Indeed, the confidence of lenders in the sector is such that its interest cover can track very close to 100%, whereas even the property companies generally operate in the range 150% - 200%. This reduces

Figure 5 EBITDA interest cover % (EBITDA % net interest paid)



the margin for error in RSL business plans, but also suggests that they lever proportionately more debt from their income than other sectors.

The greater uncertainty over earnings and the much smaller asset base (on which to secure funding) means that non-property companies require an EBITDA interest rate of over 500%.

It is notable that RSL median interest cover has improved slightly in the last two years, while in the property sector and wider economy it has declined, although this is partly driven by the increased capitalisation of major repairs undertaken to meet the Decent Homes Standard. The low level of EBITDA based interest cover does suggest that RSLs are raising as much debt as their net income streams will allow, although the income from newly

developed units and greater efficiencies within the cost base should allow the sector to continue growing.

The high level of interest cover in the non-property sector, is largely down to having relatively low debt compared to its income as illustrated in figure 6 – a median of around two times, compared to ten to 12 in the property and RSL sectors. This is to be expected, as property-based activity is particularly capital-intensive compared to the wider economy.

All sectors have seen an increase in debt multiple over the period, with non-property increasing most in percentage terms. Whereas in the property sector, the increase appears mainly to be as a result of declining earnings, in the RSL sector borrowing tends to be more for leveraging increasing

Figure 6 Net debt/EBITDA

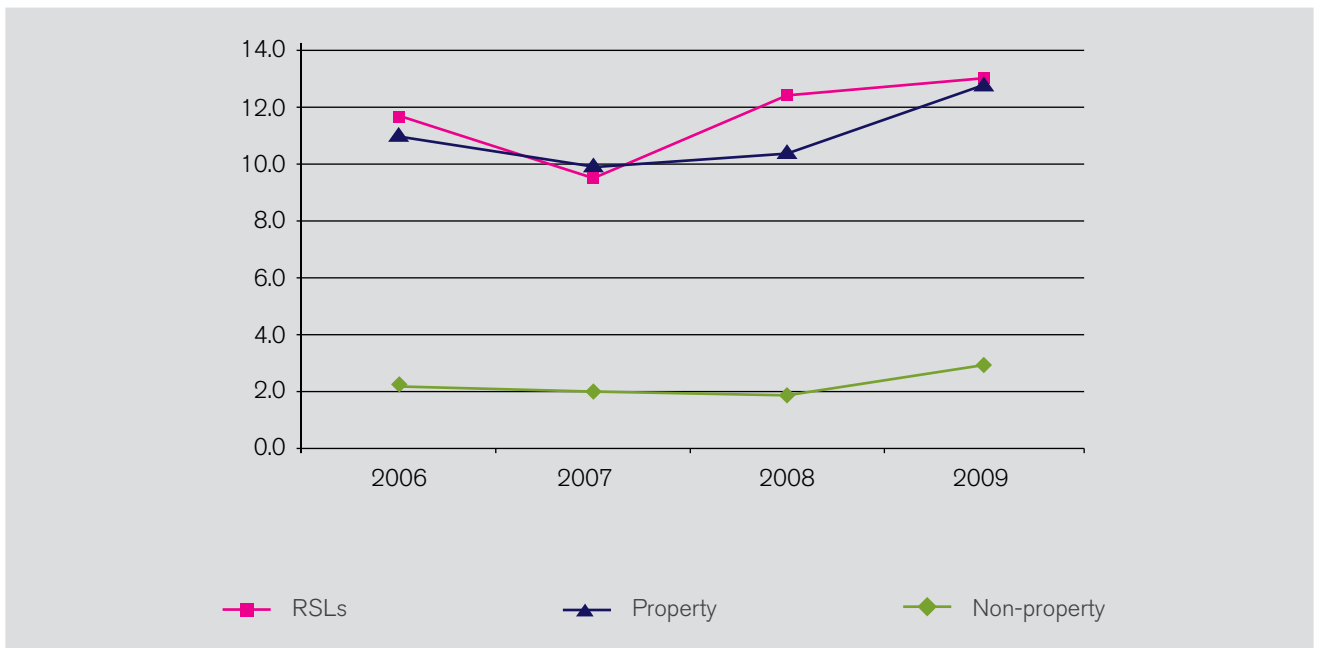
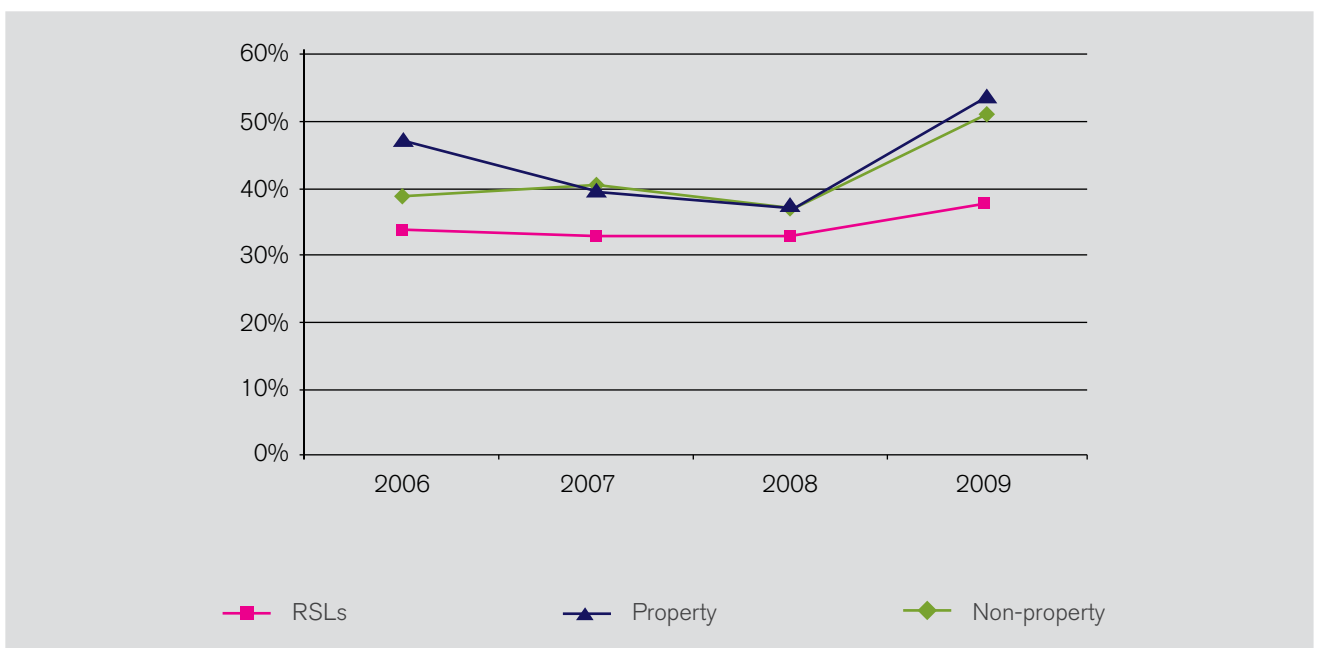


Figure 7 Adjusted net leverage % (leverage(net debt % capital employed))



surpluses for investment. This debt finance is then used to support the delivery of new affordable housing and to maintain investment in its existing stock.

Median net leverage is lower in the RSL sector than other sectors, but has followed a broadly similar trend with a dip in 2007 and 2008, followed by a large increase in 2009. In the property sector this is clearly linked to the substantial fall in asset values, while in the RSL sector and wider economy it demonstrates that it is possible to obtain financing for investment, which is encouraging.

## Conclusions on comparisons

The RSL sector has maintained stable performance amid significant fluctuations in the wider economy. In particular, it has outperformed the wider property sector and avoided substantial falls in asset values. It has also maintained turnover and even increased operating margins. Because of the stability of its income streams, the sector has been able to secure debt with very low interest cover covenants, but because of the regulated nature of its income streams its return on assets is below its peers and as a result it is relatively lowly geared.

This trade-off of stability with a lower level of return on assets, particularly compared to the wider property sector, means that RSLs offer a more secure return to investors over a long time period than is available elsewhere, which in addition, is backed by property assets.

# RSL sector performance and position

RSLs had benefited from a prolonged period of favourable economic and financial conditions in the years leading up to 2008, with low inflation and borrowing costs. The rising property market increased demand for both rental and shared ownership properties, with consumer mortgages readily available. While some factors have been less favourable – building and maintenance cost inflation, falling grant rates, policies such as rent restructuring or the Decent Homes Standard – increasing use of s106 powers by local authorities, increased the supply of properties available for RSL purchase.

Since 2008, the funding market has been severely constrained and the housing and building markets have contracted substantially. Diversification by RSLs into areas such as build-for-sale and market rent will have increased the exposure to market fluctuations, though demand for social rented housing is generally counter-cyclical and much of the rental income stream is government-sourced.

## Trading performance

Net rental income accounts for over 80% of RSL turnover and is therefore the main contributor to turnover growth. Increases are governed by the rent restructuring regime, which allows for a maximum increase of RPI+0.5%, with flexibility if the regime target rent has not been achieved. Consequently, increases in turnover in excess of RPI would be expected unless rents are reducing to target. Increases substantially in excess of RPI are likely to

be as a result of growth in the asset base adding to the number of properties rented.

The RSL sector has shown steady turnover growth throughout the period, suggesting that, to date, the credit crunch has had little effect on revenues. Indeed, growth in the upper quartile dipped in the year before the crunch – perhaps as a result of reduced new build levels – and has rebounded subsequently. Growth in turnover lower down the distribution has also increased, in excess of the rent restructuring level since 2007-08, suggesting that these RSLs are also expanding. This demonstrates the willingness of RSLs across the sector to continue to invest even in difficult economic times.

However, the level of operating surplus generated by these increased revenues has fluctuated considerably (see figure 9).

The dramatic movements in the lower quartile are more the result of changes in the spend profile of the LSVTs in the sample. However, margins across the sample have seen substantial change since 2006-07, with the aggregate average dropping more than nine per cent. However, this appears to be less as a result of the economic downturn than of policy imperatives.

While impairment charges resulting from collapsing property and land values in the sample increased over 400% between 2006-07 and 2008-09, they still represented less than one per cent of total costs. The most significant contributing factor to the decrease in average margin, was the ramping up of major repairs costs in LSVTs to meet the Decent

Figure 8 Growth in turnover %

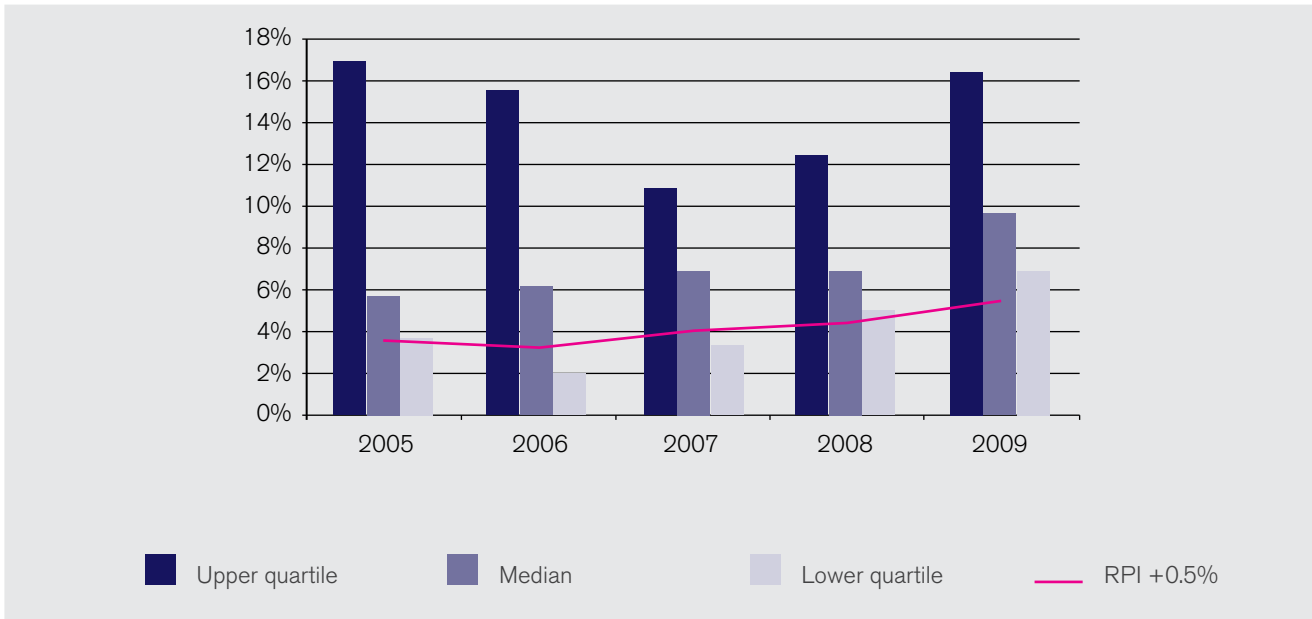
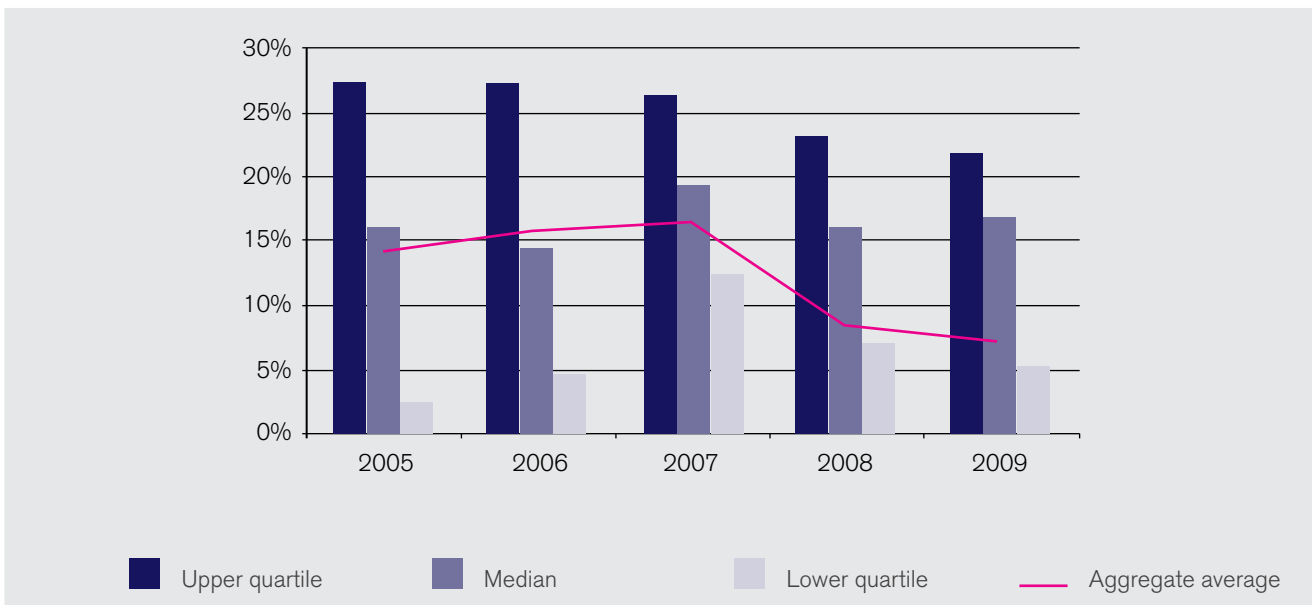


Figure 9 Operating margin %



Homes deadline. This also explains most of the fall in the lower quartile. Higher up the distribution, repairs also make a contribution, as do increasing management costs.

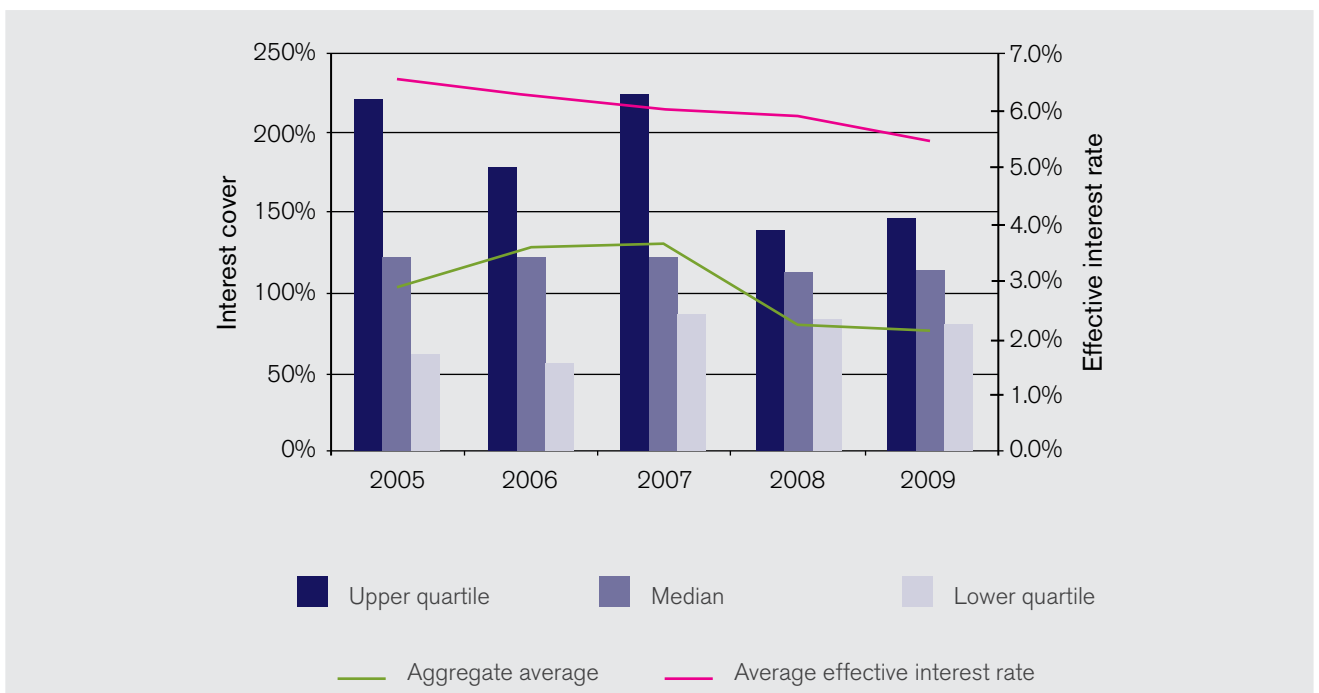
The ability to service debt is closely linked to the ability to generate surpluses, hence it is not surprising that average interest cover at the EBITDA level (excluding tax and depreciation) follows broadly the same pattern as the operating margin (see figure 10).

Given the LSVT component in the sample, it is unsurprising that the lower quartile for interest cover is below 100%, and that the decrease in margins has directly affected the level of interest

cover. However, overall interest cover indicators are reasonably healthy, with the median above 100%; the crucial consideration always being meeting lender covenants. The levels of cover achieved are lower than expected of other sectors, which gives some indication of the confidence that lenders have in RSLs.

Effective interest rates are remarkably uniform across the sector, with a gradual decline over the period. However, there has been only limited benefit from the cuts in the base rate during 2008-09, reflecting the high proportion of debt held at fixed rates and the increased margins charged by lenders since the onset of the credit crunch.

Figure 10 EBITDA interest cover %



## Balance sheet position and funding

Predictably, as operating margins have fallen, the ratio of debt to surplus has increased, though total debt in the sample has remained broadly stable. The increase in the latter stages is exaggerated by the large LSVTs in the top quartile, drawing down substantial amounts of debt.

Reassuringly, the median level of debt/surplus has not changed significantly despite the fluctuations in the market, suggesting that much of the mainstream sector is maintaining stability. This is supported by a high degree of consistency in leverage (see figure 12).

The main trend has to have been a levelling up of the lower quartile towards the median in the last two years. Since assets have not been substantially impaired, it follows that these RSLs are gearing up, which is consistent with the relatively stronger growth in turnover below the median discussed above.

As a whole, given the quality of housing assets held by the sector and the substantial proportion of properties accounted at cost rather than valuation, the level of leverage in the sector appears manageable and could potentially rise further without detrimental effect.

There is clear evidence that the increased leverage and debt is contributing to growth in assets across the sector (see figure 13).

Figure 11 Net debt/EBITDA

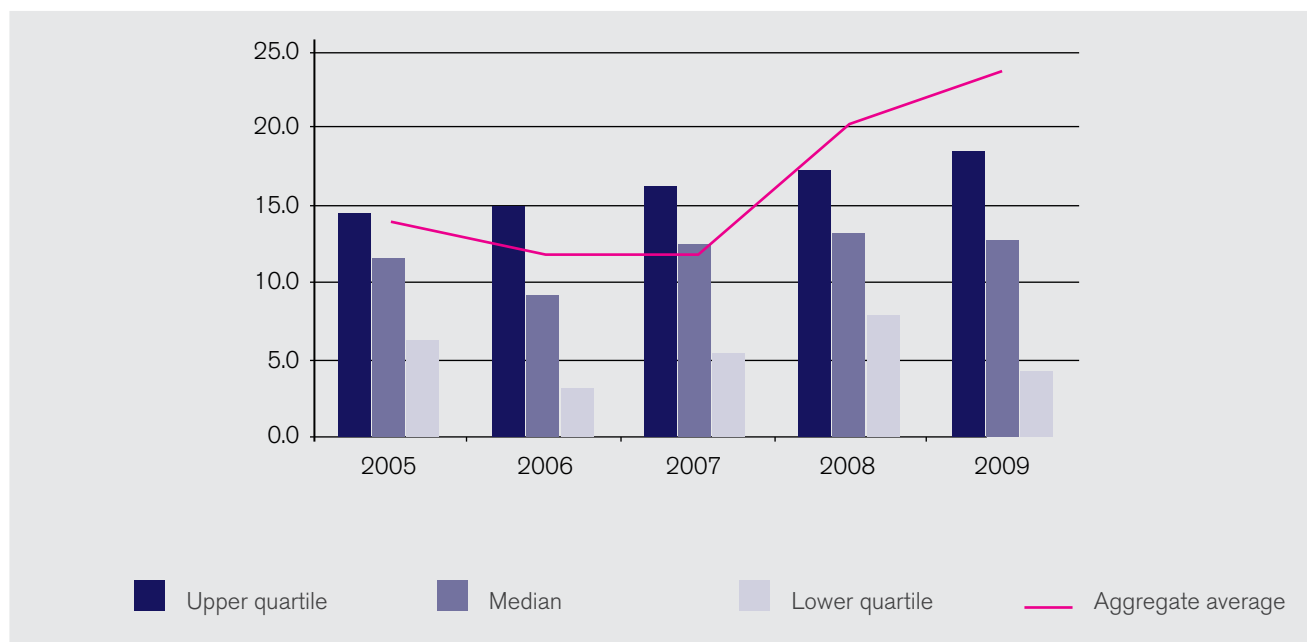


Figure 12 **Adjusted net leverage**

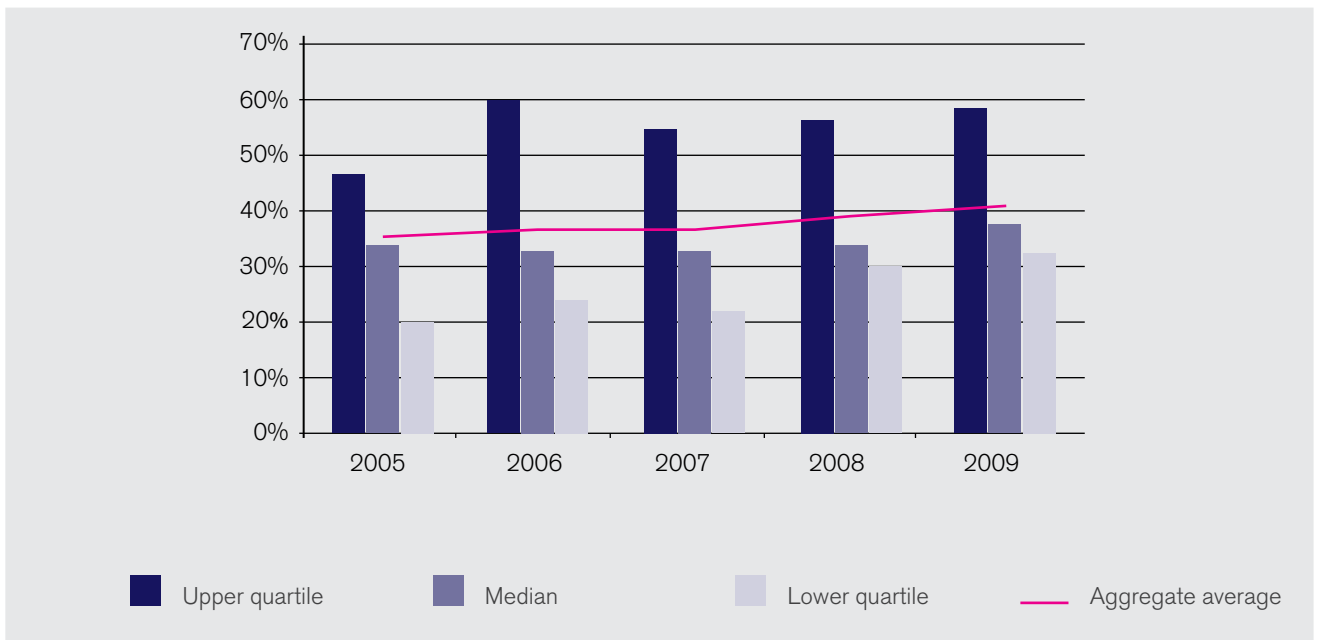
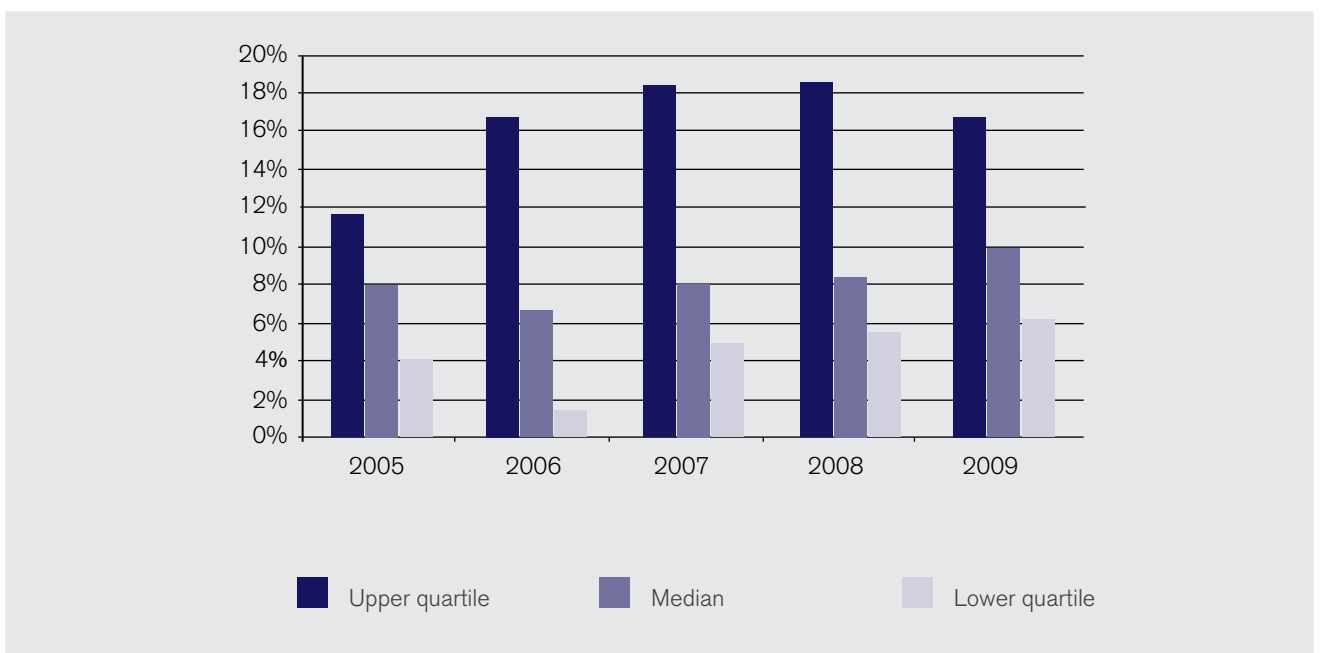


Figure 13 **Growth in total assets %**



NB Asset growth is shown net of grant

Asset growth is significantly higher than growth in turnover, but with a different trend at the top of the distribution. Upper quartile growth rates increase to 2007 and then fall away. This suggests that the reduced availability of credit and the general tightening of RSLs' cash flows since the beginning of 2008, may be putting pressure on the most ambitious associations to reduce the number of units being built. However, it is notable that over 50% of the sample showed increasing growth rates despite the funding position, and that the sector as a whole continues to show encouraging levels of growth.

## Conclusions on the RSL sector

Overall, the RSL sector's trading performance has come through the economic turbulence relatively unscathed so far. Revenues have continued to grow throughout, and while there have been some falls in margin, these can be attributed to factors other than the credit crunch. The key question going forward will be the sustainability of margins if rents remain constrained and costs continue to increase in excess of inflation, though at present most of the sector is generating enough cash to service its debt adequately.

While there has been some weakening of the sector balance sheet in terms of gradually increasing leverage and higher debt/surplus ratios, the sector has to have avoided the worst of the crash in property values. This is possibly partly due to holding many assets at cost. There continues to be substantial investment with the potential for further expansion.

# Conclusions and the future

The analysis in this study suggests that RSLs have generally maintained their performance and come through the credit crunch so far relatively unscathed. They do not generate huge returns on capital or achieve high margins – largely as a result of the external constraints on their activities – but do seem to remain steady amid the turbulence. However, this relative stability is created by a number of circumstances which may change as a result of the economic downturn and its aftermath.

While social rents are limited by the restructuring regime, they are also in part covered by the state through Housing Benefit. This provides RSL businesses with a solid, low-risk foundation for their activities. Reductions in Housing Benefit could undermine this as the balance would presumably have to be paid by tenants, increasing the risk of bad debt.

Current growth is subsidised by government grant, financed by relatively cheap money and, in many cases, achieved through private developers under s106 arrangements. Cuts in grant could either force the sector to reduce its expansion rate or find alternative sources of funding, which will increase leverage and reduce interest cover – in turn increasing lending risk and therefore lending cost. If the property market does not recover – in particular the building sector – the ready supply of suitable units will reduce and RSLs will need to develop more for themselves, potentially increasing costs further.

The stability of the sector is in large part down to the stability of the core rental business. It is noticeable that there is more volatility in growth rates and margins at the top of the RSL distribution, suggesting that more ambitious and diverse RSLs have greater exposures to the wider market. Given that most non-social housing activities undertaken by RSLs tend to involve property-related activity, and this market continues to face considerable uncertainty, further engagement will present extra risk.

# Appendix 1

## Methodology

### Analytical framework and measures

The study is based on the analysis of statutory accounting data submitted to the TSA over the last five years for a representative sample of RSLs and similar data, available in the public domain for small samples of property-based companies and non-property companies for comparison.

The study uses the ratios below to examine and compare trends in key areas such as growth,

profitability, asset structure, cash flow, gearing and credit status over up to five years. Data for the RSL sector were analysed on an aggregate basis over the period, calculating and charting upper and lower quartile values, median values and weighted average values for the sample as a whole. The same ratios were used for the other sectors if appropriate, or else an equivalent ratio was substituted.

The ratios used to profile the three sector samples were:

RSL sector	Property sector	Non-property sector	Purpose
Growth in turnover %	Same	Same	Turnover growth above inflation is needed to maintain margins and the ability to service debt
Growth in total assets %	Same	Same	The main driver and also the main consequence of business growth for traditional rental activities
Operating margin %	Same	Same	A measure of financial efficiency, credit worthiness and ability to finance growth
SBIT % total assets %	EBIT % capital employed	EBIT % capital employed	The return made on assets employed
Surplus on disposal of fixed assets % SBIT	Not used	Not used	A measure of the degree to which businesses rely on asset sales to maintain profitability
Effective interest rate %	Same	Same	The cost of funding asset growth
EBITDA interest cover %	EBITDA / Net interest paid	EBITDA / Net interest paid	A measure of ability to service debt, based on 'cash profit'

Adjusted net leverage %	Net debt % capital employed	Net debt % capital employed	A measure of the proportion of assets used to support debt
Net debt / EBITDA	Same	Same	A broad measure of the relative affordability of debt

## Sample and sources of data

### The sample

The sample consists of three distinct groups:

- a sample of 25 RSLs, including examples of the main types, geographical locations and sizes
- a group of quoted property companies, whose principal activities are property investment and development, including refurbishment and redevelopment
- a group of quoted companies from other sectors

#### Property companies

British Land Company PLC	Liberty International PLC
Big Yellow Group PLC	Segro PLC
Derwent London PLC	Shaftesbury PLC
F & C Asset Management PLC	Workplace Group PLC
Hammerson PLC	

#### Non-property companies

Barratt PLC (House building)	BAA PLC (Transport services)
Tesco PLC (Food retailing)	Debenhams (Department stores)
United Utilities PLC (utilities)	Cookson PLC (Materials science)
Invensys PLC (General engineering)	Diageo PLC (Beverages)
Vodafone PLC (Telecommunications)	Glaxo Smith Kline PLC (Pharmaceuticals)

## Data considerations

The data for RSLs were taken directly or derived from the last five FVA submissions for 2005-09. Data for the other sectors was taken from the published accounts of the selected companies for the last four years.

## Limitations

The sizes of the samples were relatively small with 25 housing associations, nine property companies and ten non-property companies.

Accounting treatment for RSL 2009 year ends changed to incorporate the 2008 SORP. The change mainly affects treatment of shared ownership properties, with first tranche sales incorporated into trading and subsequent tranches treated as capital disposals. However, there is not a material effect on comparability.

Year ends are not necessarily consistent. The RSLs all have year ends in March, whereas most of the other companies have year ends in December. For example, therefore, in 2009 there will be a mixture of data from December 2008 and March 2009, but the latest available year in all cases.

It was also not feasible consistently to aggregate the data for either the property or non-property samples so it was not possible to calculate weighted average values for the ratios in these sectors as was done with the RSL sample. Given the diverse nature of the companies involved, this could in any case have produced spurious results.

Since many of the ratios used in the TSA models are sector specific and not appropriate for other sectors, closely equivalent ratios meant that 100% direct comparisons were not possible.

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languages, on request.

## Impact of the credit crunch on housing associations

Since 2008, the funding market has been severely constrained (the 'credit crunch') and the housing and building markets have contracted substantially. This publication explains how the housing association sector's business model means that it has been well placed to deal with the impact of the recession.

