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CHC Finance & IT Conference July 2017

Funding in a changing environment

Henrietta Podd, Director

Funding in a changing environment

- Welsh Housing Associations have not been exposed to the same level of change as English Associations. In particular,
  - Rents still have a positive link to inflation, and
  - larger volumes of grant are still available

- However, they are having to manage the impact of
  - Welfare Reform
  - Economic uncertainty
  - Demographic change and
  - Changes in the funding markets and rate volatility

- And … the current relatively benign regulatory and grant regime may not go on for ever.

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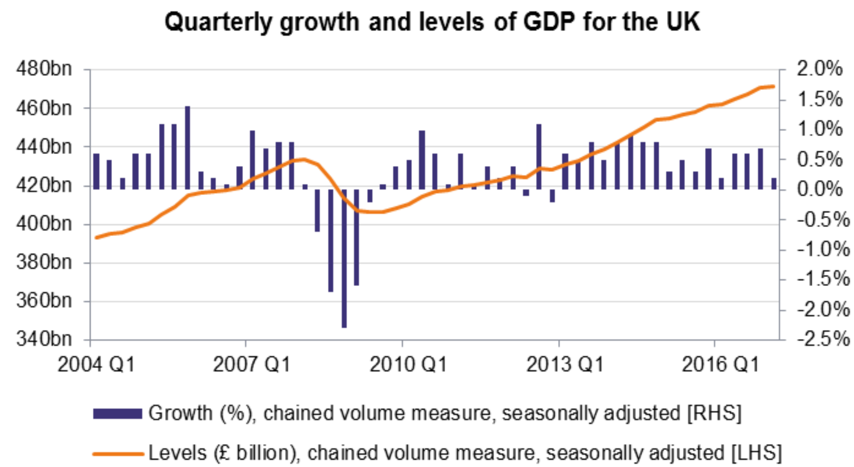
Funding in a changing environment

- How is the economic and funding environment changing?
- What are the options for raising new finance?
- How can Welsh Associations ensure they have efficient and cost effective access to funding?

Economic Environment

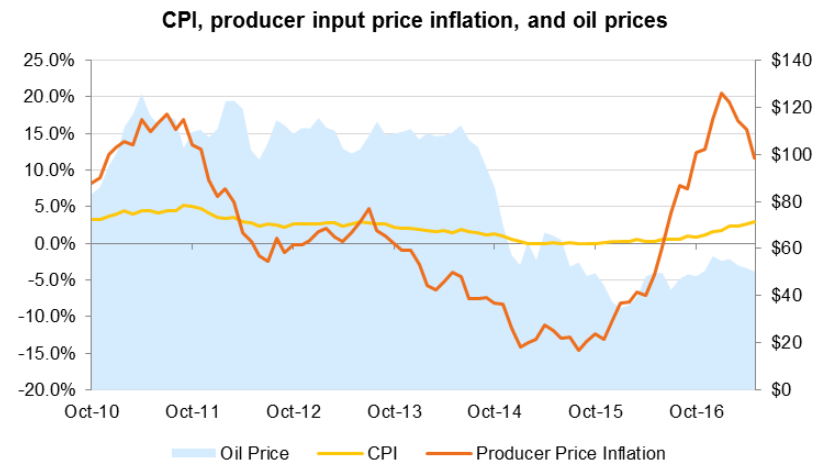
Slower GDP growth but strong employment data

- Consumers squeezed as inflation decreases purchasing power
- Pay growth continued, with average weekly earnings rising by 2.1% y-o-y
  - But real wage growth negative at -0.8% versus 1.9% a year ago
- Offset by
  - low unemployment and good availability of credit, but
  - business investment and exports need to increase
- Longer-term uncertainty with larger trends likely to be dictated by how:
  - Businesses react to Brexit unknowns
  - Firms balance cheaper exports against rising import costs
  - Consumers react to household inflation



Inflation & Exchange rate

- Biggest change in the UK economy since mid 2016
  - CPI at 2.9% in May its highest since the mid 2013; RPI was 3.7%,
- A large part is down to declines in the exchange rate
- Trade weighted sterling down c. 12% from pre-Brexit levels.
- Oil prices up 70% from their lows in January 2016



Interest rates - the BoE

- June MPC meeting, vote was 5-3 to keep the bank rate at 0.25%,
- Growing dissent among members on timing of rate hike
  - Some, including Governor Carney, want to keep rates low given future uncertainty around growth and the impact of Brexit
  - Andy Haldane, Chief Economist may vote for hike later in year.
  - Others see inflation rising faster and further, justifying an increase in rates sooner

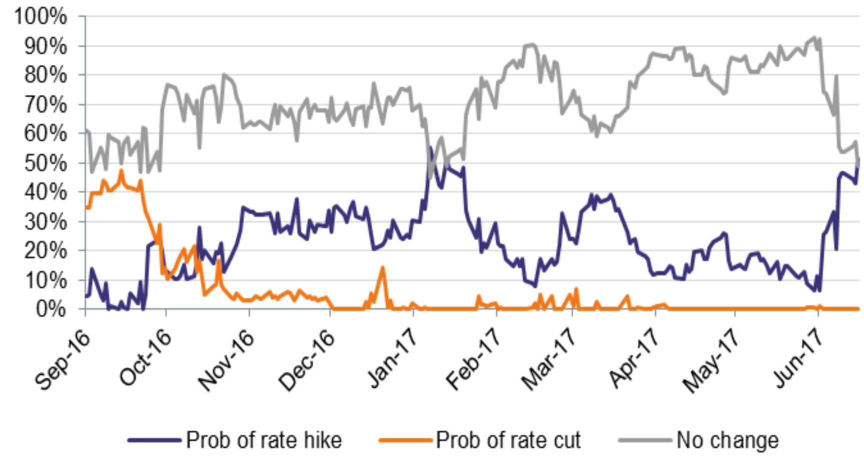
This has been very disruptive to gilt market in second half of June

- Markets now predicting a 51% chance of hike by end of year.

Direction of rates

- Number of commentators agree, believing last year's rate cut may be reversed by year end.
- Other economic forecasters like Capital Economics look for stronger economic recovery so see the first rate rise well into 2018
- They are forecasting that long rates will go up more sharply – and this has already started to happen.

Probability of a rate hike/cut by end of 2017



CAPITAL ECONOMICS

Forecasts (July 2017)

End Period (%)	4th Jul.	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q4 19	Q4 20
Bank Rate	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.75	1.25	2.25
3-month LIBOR	0.30	0.31	0.30	0.30	0.50	0.60	0.70	0.80	1.50	2.50
6-month LIBOR	0.46	0.46	0.40	0.50	0.60	0.70	0.90	1.00	1.80	2.80
10-year Gilt Yield	1.25	1.26	1.38	1.50	1.75	2.00	2.25	2.50	2.50	3.00
30-year Gilt Yield	1.86	1.89	2.03	2.15	2.40	2.65	2.90	3.15	3.20	3.70
$/£	1.29	1.30	1.30	1.30	1.31	1.33	1.34	1.35	1.40	-
€/£	1.14	1.14	1.16	1.18	1.18	1.18	1.18	1.17	1.17	-
TWI	77.4	77.5	78.6	79.7	79.8	80.0	80.1	80.2	80.5	-
GDP (% q/q)	0.2	0.4	0.5	0.6	0.6	0.6	0.6	0.6	-	-
GDP (% y/y)	2.0	1.7	1.7	1.7	2.1	2.4	2.4	2.4	2.0*	2.0*
CPI inflation	2.9	2.7	3.1	2.9	2.7	2.5	2.3	2.2	1.9	1.8
RPI inflation	3.4	3.7	3.9	3.5	3.3	3.3	3.2	3.3	3.1	3.4

*Annual

Sources – Capital Economics, Thomson Reuters

Interest rates - gilts & swaps

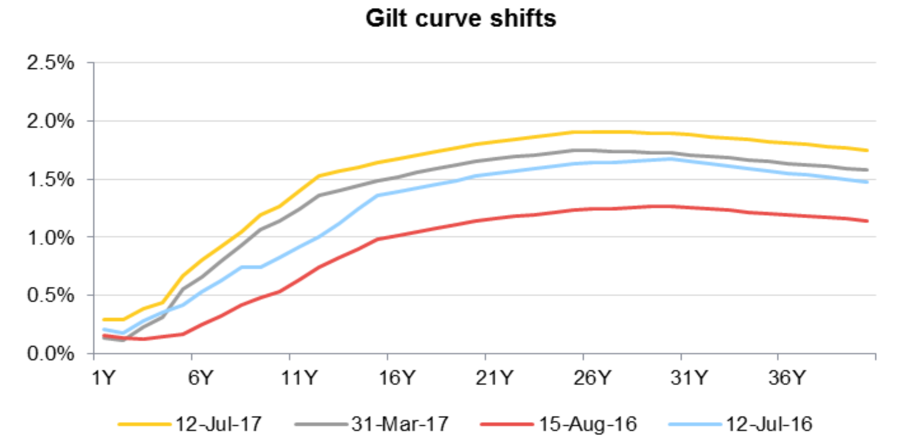
- The gilt market has been very volatile since the publication of the last inflation data.
- Mixed messages from the BoE has also been very disruptive.
  - Gilt yields and swap rates have been up 50-70bps at the medium-to-long end of the curve since their lows in August of last year
  - With the market selling off 0.25% (in yield) over the last two weeks of June 2017
- Concern has also been expressed by the rapid growth in consumer credit with the implicit message that the BoE should not leave the rate rise too long

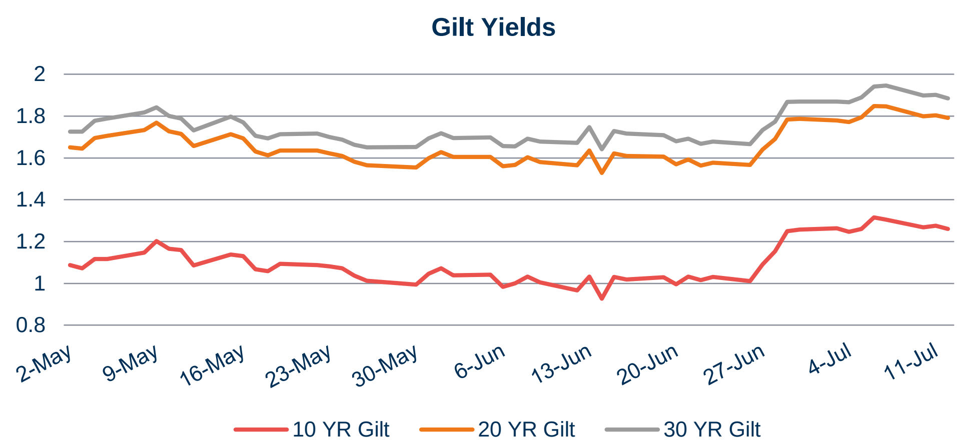
This echoes warnings from the BIS that “if [central banks] leave it too late, it is going to be much more difficult to accomplish [that] unwinding”

- Longer term rates are now broadly back to pre Brexit referendum levels

So borrowers going to the markets now have to consider:

- Rising rates
- More uncertainty
- Likely rush to market





Changes in the funding markets

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Bank and Bond Markets

- 2015-16 was a good time in the funding markets for HAs
  - Relatively low short and long term rates
  - Banks willing to lend & negotiate on legacy loans
  - Institutions willing to invest
  - Funding available from AHF and EIB
  - Local Authorities beginning to lend to HAs
  - Credit ratings had settled down
- While rates have fallen further in the last year to 15 months
  - No more AHF, and doubts over EIB
  - No signs that bank margins are tightening, and covenants and security requirements are tighter
  - Fewer active UK private placement investors
    - Less competitive pricing
    - Demanding bank style covenants

	Margin to Libor	Upfront & Commitment fees
3 year RCF	0.75-1%	0.4-0.6% 40-50% of margin
5 Year RCF	1 -1.35%	0.5-1% 40-50% of margin
10 year term loan	1.5-1.85%	1%

	15 years (Margin to gilts)	30 years (Margin to gilts)
Private placement	+1.5 - 1.8%	1.6 – 2%
Public bond issue (Tier 2)	1.00 – 1.50%	1.10 – 1.60%

PPs	Creeping covenants
	▪ EBITDA –MRI ▪ Gearing ▪ On Lending ▪ Merger consent ▪ Disposals

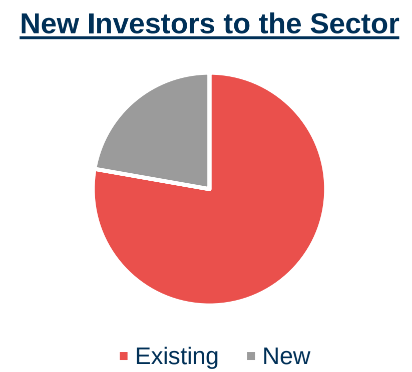
However, institutional investors like Welsh credits …

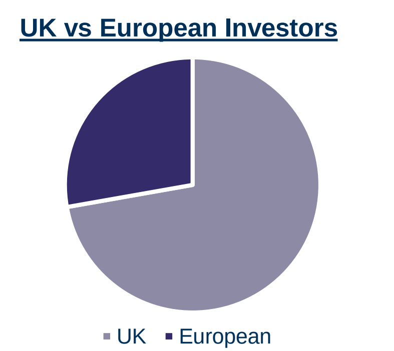
Recent case study: Pennaf Housing Group

£160m 3.21% Secured Bond 2052 + £90m Retained Bonds

- **Key features:**
  - First public bond for a Welsh Housing Association
  - Priced at 155bps over the gilts – only 15bps wide of the £400m Martlet deal (Hyde)
  - Rated A/A3 by S&P / Moody's
  - Amortising structure rare in public markets
  - 3.5x over-subscribed - £550m of demand from 18 investors, 4 new to the sector

- **Key takeaways:**
  - Considerable resource committed to investor presentation
  - Significant value placed on Welsh regulatory framework and commitment to the sector
  - Covenant-lite bond replacing covenant-heavy bank lending
  - Executed from standing-start within two months including new rating from S&P
  - Reduces running-cost of debt, increases flexibility of the business plan
  - Currently trading only 5 bpts wide of Martlet





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Supply and Demand

Public Bonds

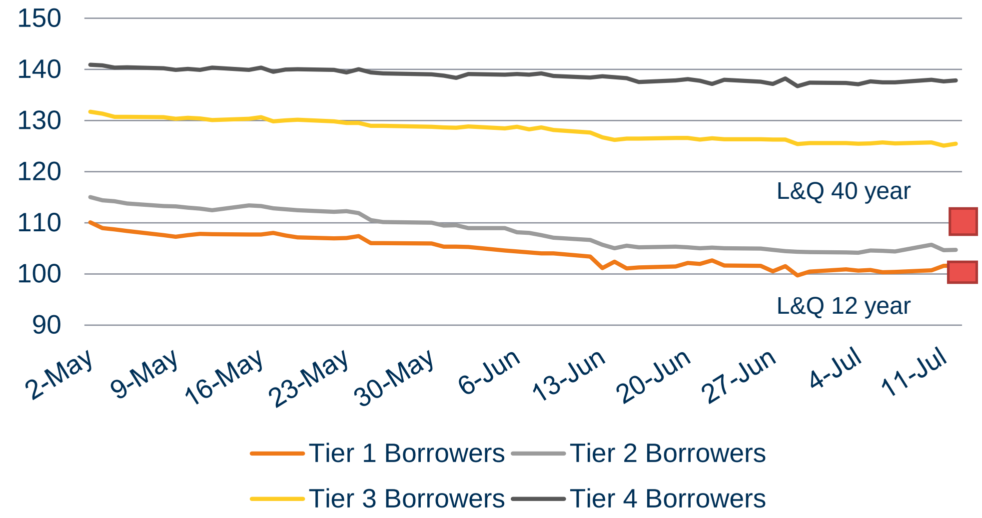
- 2016 was a very quiet year for HA public bonds – partly due to HAs using AHF and partly regulatory change in England.

- Activity has also been slow in 2017 with 4 issues – all of which have been designed to meet investor demand
  - £400m Martlet
  - £250m Pennaf
  - £500m L&Q in two tranches

  + some RB sales

- All have funded in a range of
  - 12 to 40 year
  - 2.35 to 3.22%

Secondary Housing Association Margin to Gilts – Listed Bonds



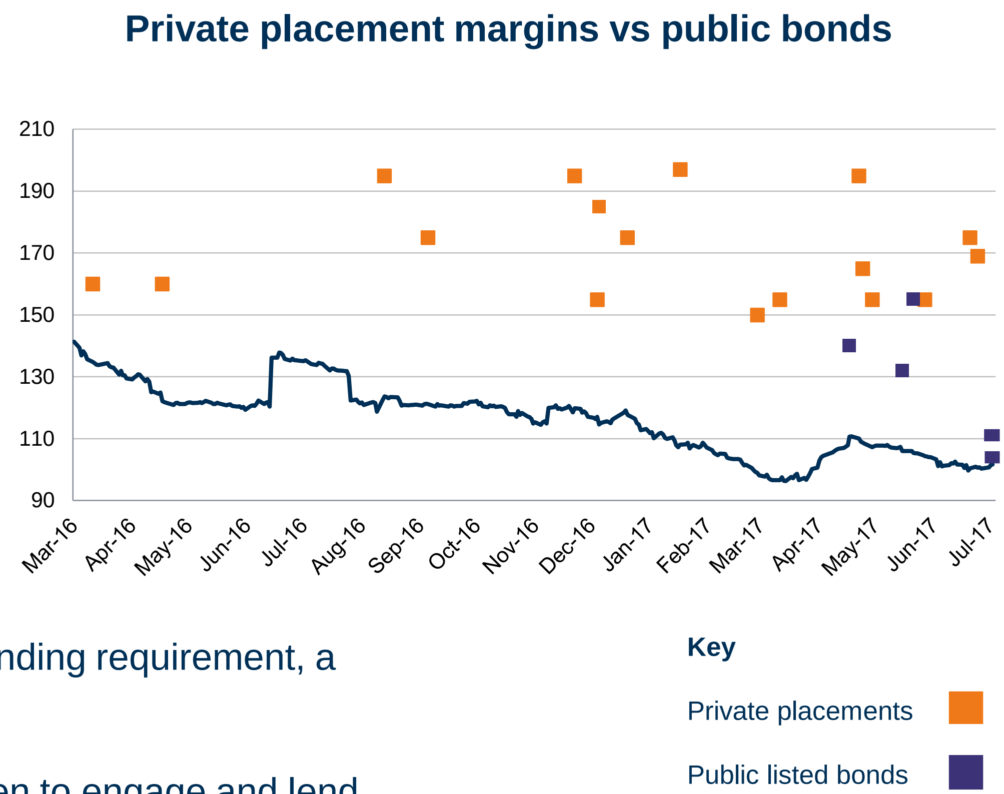
HA Sterling Bond Market									
New Issues	1995-09	2010	2011	2012	2013	2014	2015	2016	2017
No of bonds	11	3	4	18	5	17	8	4	4
Volume issued (£' billion)	2.1	0.9	0.9	3.6	1.7b	2.9b	1.5b	1.0	1.06
Average maturity (yrs)	29.8	26.1	25.1	28.9	29.8	28.2	29.1	10.5	30
Average spread (bps)	137	108	158	186	136	132	137	187	125

Note: Listed issues only. Excludes AHF, group borrowers and PPs. Does not include retained bond sales. 2016 issues shorter dated and 3 were unsecured. 2017 is year to date.

Supply and Demand

Private placements

- A proliferation of private placements has led to:
  - At least one investors pulling back from the market
  - A hardening of terms with some investors looking for bank style covenants
  - Lack of competitive tension in pricing



- As a result, for those with a more substantial funding requirement, a small public bond may be competitive.

- For smaller borrowers, US investors remain keen to engage and lend in sterling out to 20 years

- However, other capital market solutions may better suit those with a modest requirement

Armed to face changing markets

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Short term

- Diversify funding sources and prepare to engage with new lenders
- Understand the credit strengths & weaknesses of the business
  - Political and regulatory support key to credit strength
- Present accurately but not modestly
  - Ensure assumptions are not overly conservative
  - Identify exceptional costs
  - Show discretionary spend as a social dividend
- Address weaknesses upfront with strategy to manage them.
- Ensure reporting of financial & treasury risk is clear and consistent for the board decision making
- Consider a credit rating

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Research Update:

Wales-Based Social Housing Association Pennaf Limited Assigned 'A' Rating; Outlook Stable

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Rationale

Our 'A' rating on Pennaf is based on its 'a-' stand-alone credit profile, and on our opinion that the Welsh government is highly likely to provide timely and sufficient extraordinary support to Pennaf in the event of financial distress.

We base our view of the high likelihood of extraordinary government support on the important role that Pennaf plays for the delivery of the Welsh government's affordable housing policy. At the same time, we see a very strong link with the Welsh government given its strong regulatory oversight and track record of timely support.

We consider that the social housing industry exhibits low risk globally given the low cyclicality, high demand, and government support. More specifically, we see strong demand for social housing in Wales, particularly in areas where Pennaf operates. Social rent of about £85 a week is still 35% below relevant market rents, which supports demand. Furthermore, the low exposure to

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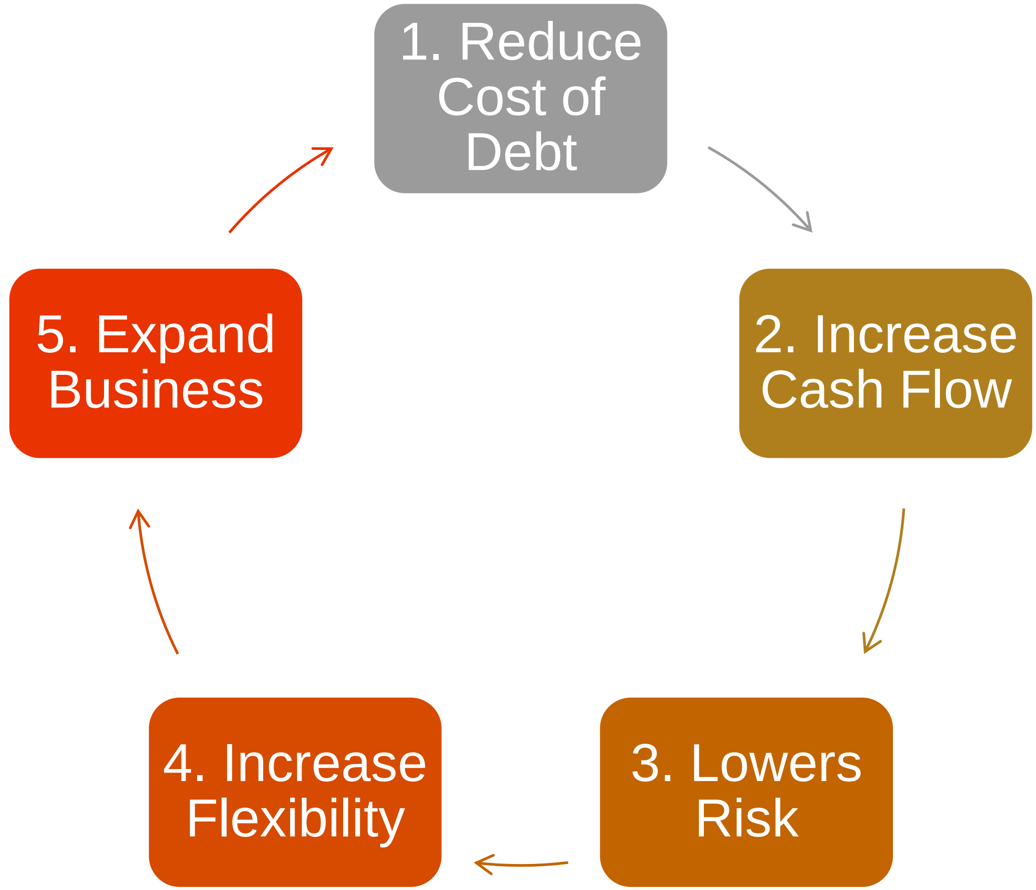
Longer term

- Build up risk buffers
  - Enhance bottom line surpluses
    - Not just through operational efficiency but reducing funding costs

- Consider liquidity
  - Generating it – less focus on operating margins, and more on free cash
    - Access to it
      - Do you hold enough cash
      - Are facilities ready to draw

- Consider whether legacy debt is now an operational risk and constraint on the business



Group Borrowing

- Welsh housing associations have in the past
  - Accessed THFC
  - Worked on a collaborative basis to arrange borrowing
- A group of Scottish, English and Northern Irish Housing Associations have engaged in a feasibility exercise to look at a new group borrower:
  - Owned and governed by housing associations
  - Using modern issuance methods to speed access to the market
  - With a minimum credit rating of A+
  - With more efficient collateral and credit arrangements
    - Pre agreed credit lines
    - Longer period to pledge assets
    - Ability to pledge a proportion of non-general needs assets

Appendix

A Borrowing Vehicle for the Sector

The problem

The debt requirements of most Housing Associations are ill suited to the needs of the capital markets.

- £10 - 50m of new funding each year
- generally driving small illiquid issues
- that are (expensive) for investors to monitor

HA Sterling Bond Market									
Total Issues	1995-09	2010	2011	2012	2013	2014	2015	2016	2017
No of Bonds	11	14	18	36	41	58	66	70	72
No of Issuers	7	10	14	24	33	46	51	51	53
Total outstanding £bn	2.1	2.9	3.8	7.4	9.0	11.9	13.4	14.4	16.4
Average deal size (£' million)	186.8	207.5	211.1	204.6	220.7	205.8	203.6	206.1	227.7
New Issues	1995-09	2010	2011	2012	2013	2014	2015	2016	2017
No of bonds	11	3	4	18	5	17	8	4	2
Volume issued (£' billion)	2.1	0.9	0.9	3.6	1.7b	2.9b	1.5b	1.0	0.66
Average maturity (yrs)	29.8	26.1	25.1	28.9	29.8	28.2	29.1	10.5	39.9
Average spread (bps)	137	108	158	186	136	132	137	187	151
Note: Listed issues only. Excludes AHF, group borrowers and PPs. Does not include retained bond sales. 2016 issues shorter dated and 3 were unsecured. 2017 is year to date.									

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The problem

At a time when investors are increasingly focused on:

- large repeat index eligible issues (£500m -1,000m)
- with dependable secondary market trading
- that are easy to monitor
- competitive market

Large Corporate Issues – 2017 (*greater than £400m)				
Issuer Name	**Issue Date**	**Amount Issued**	**BBG Composite**	**# in issue (GBP)**
Thames Water Utilities Cayman Finance	24 Jan - 24 May	£1,867m	A-	37
Unilever PLC	03-Feb	£438m	A+	3
BP Capital Markets PLC	14-Feb	£499m	A	4
Motability Operations Group PLC	14-Mar	£426m	A+	7
Volkswagen Financial Services NV	12-Apr	£1,062m	A-	7
Procter & Gamble Co/The	03-May	£969m	AA-	4
Channel Link Enterprises Finance PLC	06-Jun	£884m	BBB	9

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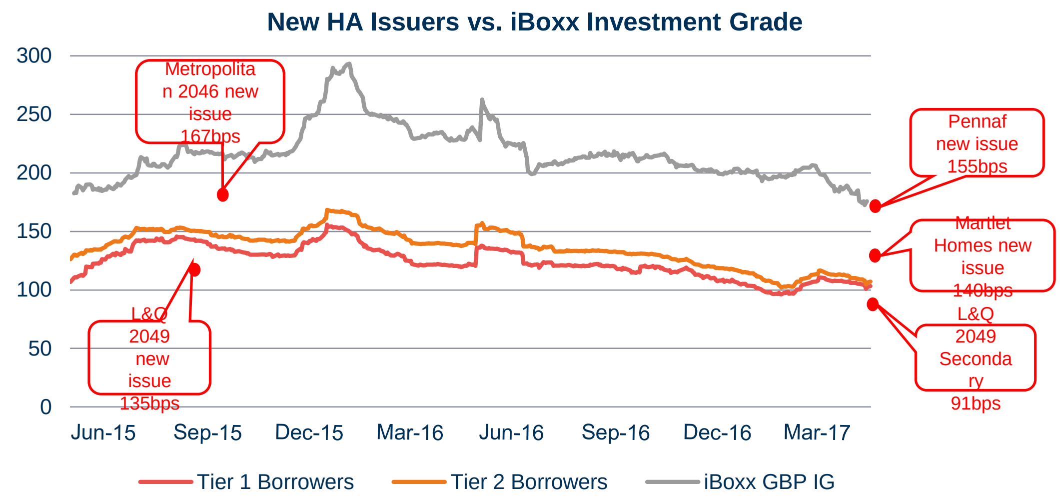
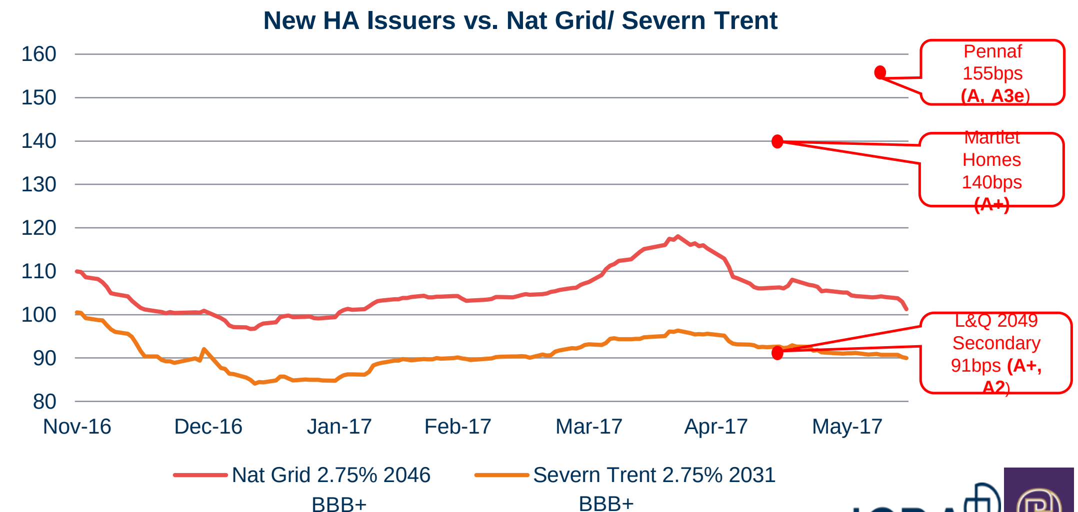
The result

As a result, Housing Associations face increasing problems on accessing the market

- a process that is
  - ➢ expensive,
  - ➢ inflexible,
  - ➢ time consuming
- limited appetite from investors
  - ➢ only 10 – 20 core investors
- growing requirements for covenants
  - ➢ gearing/interest cover/onlending etc
- increasing margins over gilts
  - ➢ 140 - 160 over gilts
  - ➢ not 80 -100 over gilts





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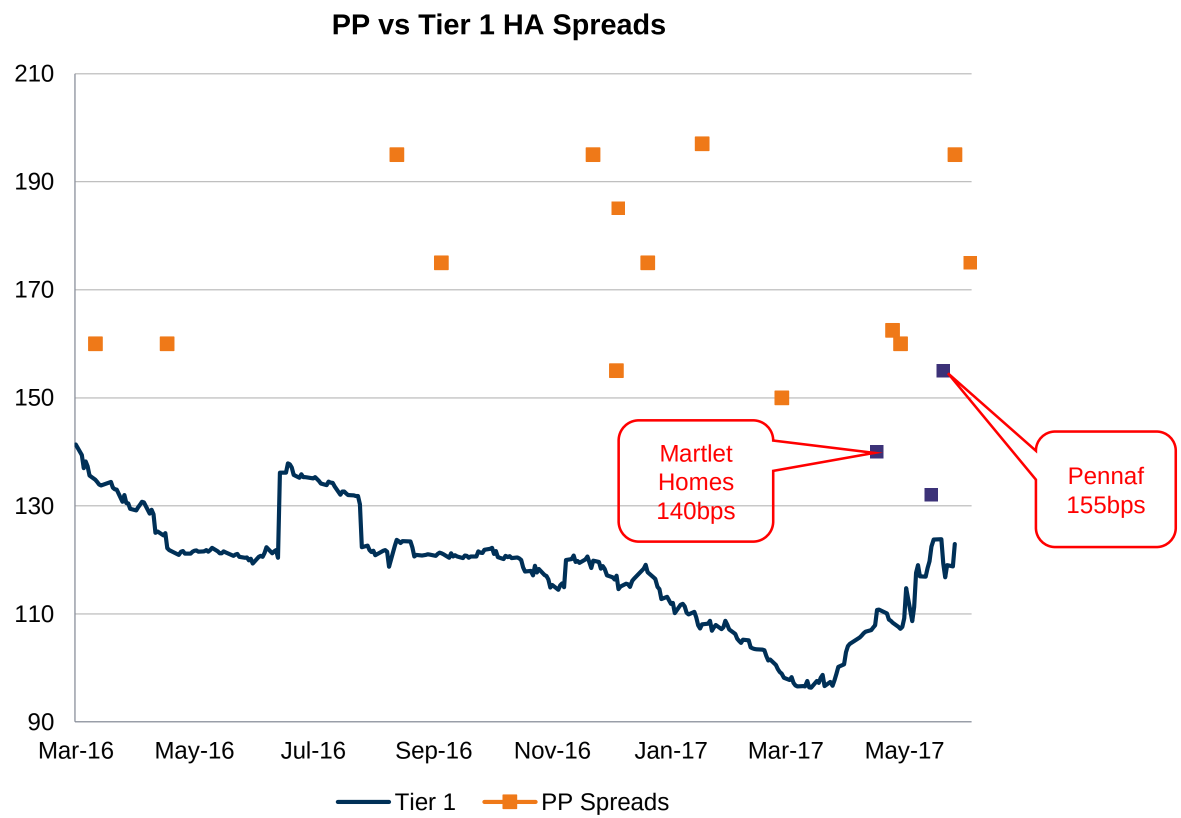
The result

And the situation is even worse in the private placement market.

Since March 2016

- 14 issues
- For a total £1,350 million
- Average spread of 168.6 bps
- Extra cost
  - ➢ £10m p.a. or
  - ➢ £200m over 20 years



The solution

Housing Associations are one of the largest and best rated groups of borrowers in the sterling market

Average credit rating

- A2 Moody's
- A+ S&P

Total debt

- total Housing Association debt* - £66.7 billion
- extra debt last 12 months* - £2.2 billion

By acting together they can issue bonds that are

- large
- liquid
- well rated, and
- easy to monitor

Moodys	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Feb-17
Aaa	-	-	-	-	-	-	-	-	-	-	-	-
Aa1	-	-	-	-	-	-	-	-	-	-	-	-
Aa2	1	3	2	3	4	7	10	-	-	-	-	-
Aa3	-	-	2	2	3	4	12	2	3	3	2	2
A1	-	-	-	1	1	1	2	12	12	14	13	13
A2	-	-	-	-	-	-	-	16	20	21	21	21
A3	-	-	-	-	-	-	-	2	2	3	5	4
Baa1	-	-	-	-	-	-	-	-	-	1	2	2
Total	***1***	***3***	***4***	***6***	***8***	***12***	***24***	***32***	***37***	***42***	***43***	***42***

S&P	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Feb-17
AAA	-	-	-	-	-	-	-	-	-	-	-	-
AA+	-	-	-	-	-	-	-	-	-	-	-	-
AA	-	-	-	-	-	-	1	1	2	4	-	-
AA-	-	-	-	3	3	3	2	5	12	15	2	2
A+	-	-	1	2	2	2	2	2	3	3	19	19
A	3	3	2	-	-	-	-	-	-	-	5	5
A-	-	-	-	-	-	-	-	-	-	-	-	-
Total	***3***	***3***	***3***	***5***	***5***	***5***	***5***	***8***	***17***	***22***	***26***	***26***

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The key to success

To succeed, the borrowing vehicle needs to offer

- £1.0bn or more of new issues per annum
- a rating of at least A+/A1
- loans to a wide range of borrowers
- using a simple and transparent structure

This will make it the largest single borrower of sterling bonds

- a “must buy” for investors
- a “must act for” with lead managers

The benefits

Correctly structured it will provide a wide range of benefits

These are focused on three things:

1. A lower cost of debt
   - a saving of at least 25bps per annum

2. More flexible access to the market
   - wider range of maturities
   - wider range of amounts

3. A more user friendly product
   - greater security efficiency
   - simple standard loan document
   - no vexatious corporate covenants

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So how does it work?

- a Public Limited Company (PLC)

- wholly or majority owned by HAs

- takes risk on the underlying HA borrowers

- credit enhancement through
    - subordinated debt
    - standby liquidity lines

- issuance through a medium term note programme
    - substantial dealer group
    - provision for rapid market access

- minimum rating of A+

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So how does it work?

- operates a transparent credit model to allocate limits to individual borrowers
- provides annual borrowing allocations
- borrowing within the credit limit at 1 weeks notice
- 18 months to pledge assets
- inner limit for alternative assets
  - Care Homes
  - Shared ownership
  - PRS
- master loan agreement
  - no corporate covenants
  - no vexatious operating covenants
  - “subsequent series” provisions

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So what will it cost?

Stage	Amount	No. Of Sponsors	Cost Per Sponsor
1. Initial Stage	£50,000	14	Capped at £5,000
2. Detailed Scoping	£200,000	At least 25	Capped at £10,000
3. Implementation*	£300,000 - £525,000	At least 25	Set at stage 3
4. Bond issue	Depends on borrowing	N/A	

*Note: stage 3 can only be scoped as part of stage 2

So what does stage 2 involve?

• Building/Validating the enhancement model	
➢ Equity Capital/Subordinated debt	25,000
• Building/validating the credit analysis model	
➢ For granting loans to HA’s	25,000
• Agreeing parameters with Rating Agencies	
➢ Validation from Moody’s/S&P	75,000
• Checking Legal/tax structure	
➢ Explore loan documentary/tax issues	25.000
• Exploring the model with investors	
➢ To obtain indication of demand/pricing	25,000
• Miscellaneous expenses	
➢ Potential cost overruns	25,000
Total	**200,000**

Designed by HAs, Owned by HAs, to meet the needs of HAs

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153 USD

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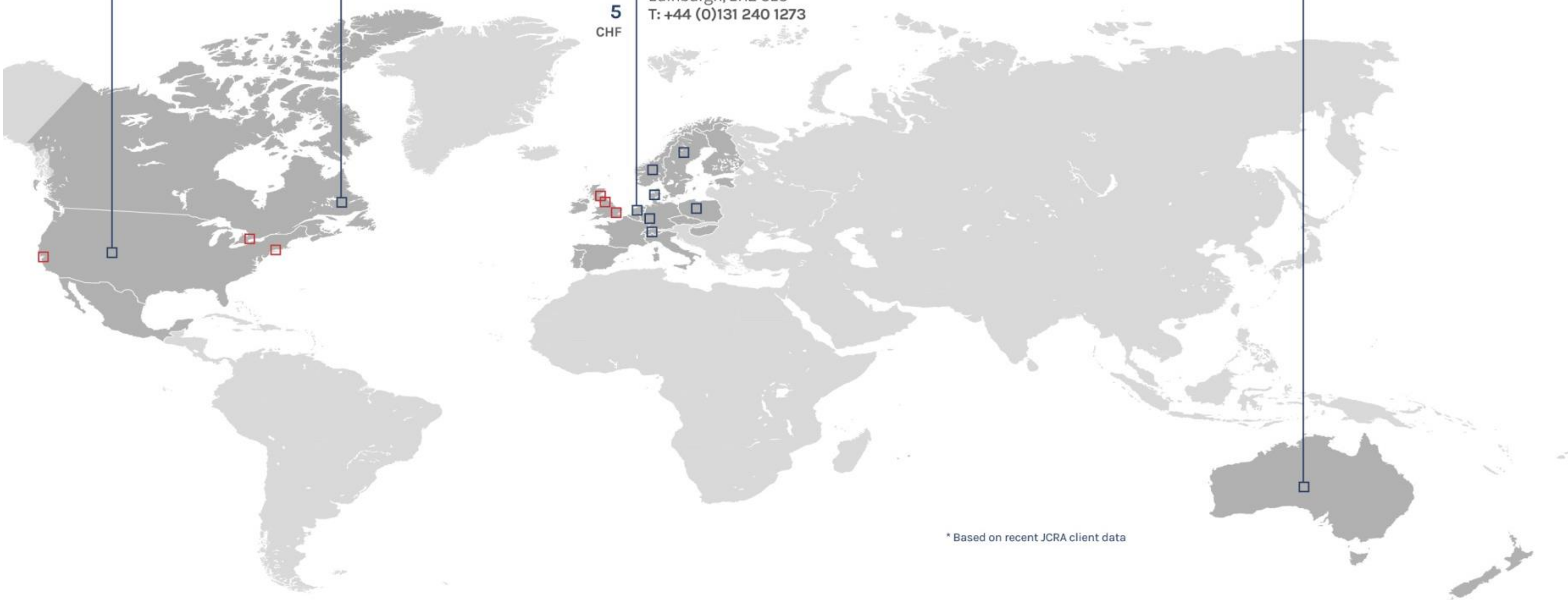
JCRA recent transactions by currency

Australasia

9 AUD



* Based on recent JCRA client data

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