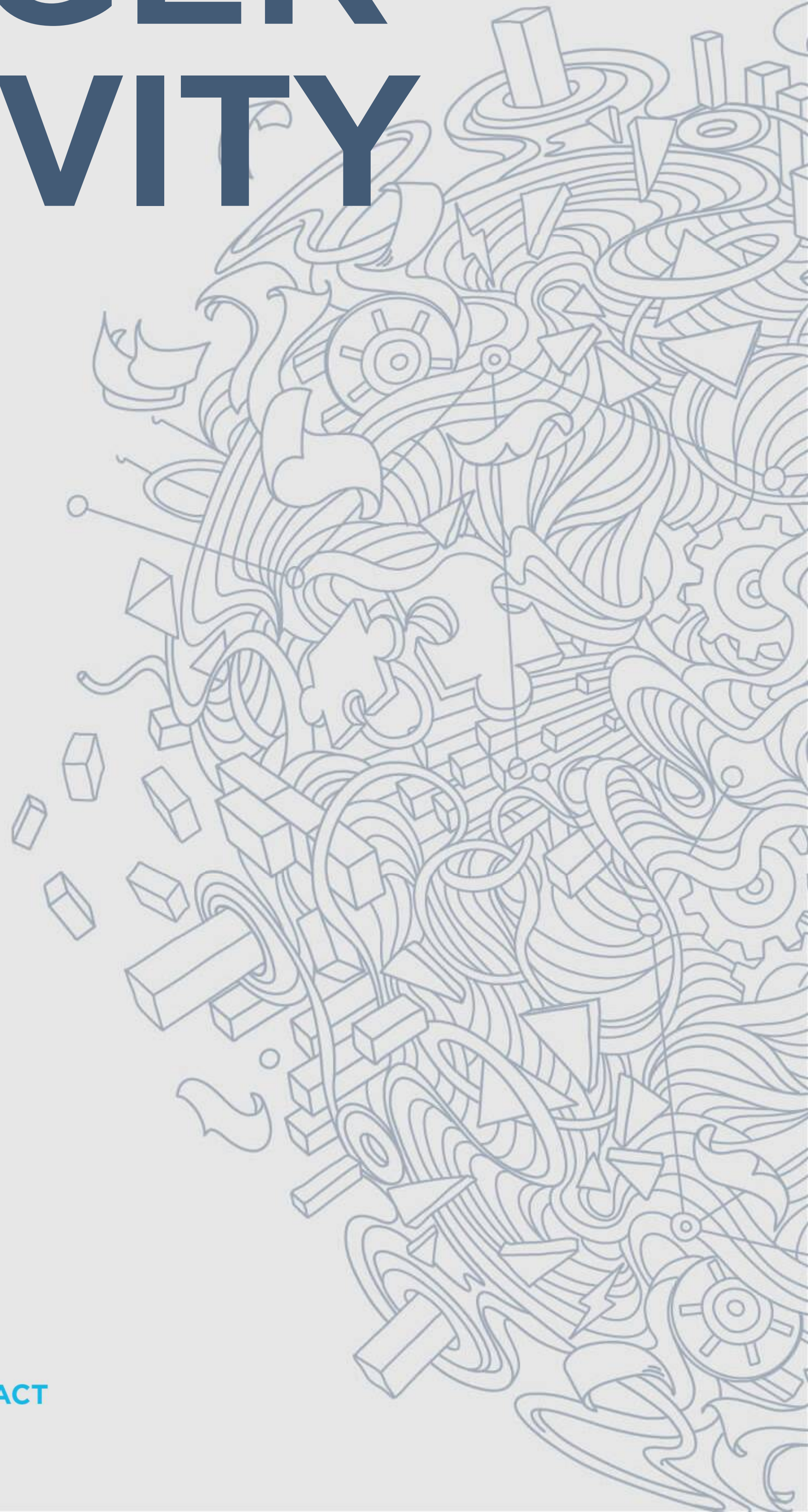
FLURRY OF MERGER ACTIVITY



ADDLESHAW GODDARD

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HOW HAVE FUNDERS REACTED TO THIS FLURRY OF MERGER ACTIVITY?

Following up on my previous article "The story behind the recent merger trend within the social housing market", this article explores how the recent merger activity amongst housing associations has impacted funders, and how different types of funders can embrace the growing trend of mergers within this sector.

As discussed, there are a number of rationales as to why a housing association would consider merging, which range from pursuing economies of scale to meeting the demands of government.

One additional result of the recent merger activity, which will hopefully continue if future mergers currently on the horizon also succeed, is improved levels of corporate governance and operational capability amongst housing associations, making the housing sector better equipped to attract the funds it requires.

Being able to attract these funds is becoming imperative for housing providers. Fitch warned at the end of last year that the housing sector will need an extra £47bn over the next five years in debt facilities for decarbonisation and building improvements alone. To attract these funds, many housing providers believe merging is the right course of action. As stated by Jonathan Walters, deputy chief executive of the Regulator of Social Housing, mergers are potentially being "driven from a financial perspective".

As a result of increasing merger activity S&P have forecast that by the end of FY23, all borrowing across the sector will rise to around £107bn. This highlights the fact that housing associations are keen to borrow more to ensure compliance with new and existing regulations, to meet costs and try to meet governmental expectations to build new homes. This increased level of borrowing also demonstrates an appetite from different types of funders to invest in the housing sector, with funders taking a proactive approach to merger activity.

As flagged by Savills in their publication "Spotlight: Private Money and Affordable Housing", funders have identified that the affordable housing sector has "favourable long term structural demand drivers, liability matching return characteristics, with the potential for growth and insulation from volatility... best opportunity for social impact and long term investors are increasingly looking for ethical opportunities". Current and further merger activity will further enhance the willingness to invest in this sector.

Furthermore, the financing possibilities for housing associations have broadened over time, as seen with the emergence of the Euro medium-term note programmes. From a housing association perspective, the prospect of a merger is made more enticing by the potential to create a bigger pool of security and assets to enable further borrowing, and to take advantage of the influx of new investors. The enhanced spotlight on the sector has meant an increasing number of new investors looking to provide an inflow of capital either to these larger housing associations or to those who have recently merged (with the improved levels of corporate governance which tend to drive a successful merger). Thus, the current funding market is favourable to these housing associations, enabling them to access structures previously not available in a variety of ticket sizes and at very competitive levels.

Savills Affordable Housing Consultancy recently argued, in their article "Spotlight: Housing Association Finance" that housing associations merging could increase their financial capacity and ease financial pressures. This is illustrated by Blend raising £75m for GreenSquareAccord Limited soon after its merger in April 2021.

However, with more choices of funding available, newly-merged housing associations are looking for more from their funders beyond just financing. As recently highlighted by Maria Goroh, director of investor coverage for Centrus, housing associations are increasingly seeking long term funding partners that understand their business, and long term support, providing bespoke funding structures, covenants and deferred drawdowns, whilst providing associations with the ability to quickly top up their funding. This was case following the merger between Riverside and One Housing which created a 75,000 unit housing association aiming to spend £500m on the decarbonisation of existing stock, with these funds becoming more easily available following the merger.

Historically, housing associations have taken a reactive approach to funding arrangements following a merger, due to having significant legacy bank loans that have great value due to low margins. However, these loans usually come with specific covenants which do not provide the flexibility that associations desire, including on-lending restrictions. However, this has prompted more housing associations to look into other types of funding, in particular debt capital markets. As S&P stated, "capital markets will remain associations' primary source of funding" as the larger and more efficient entities become more appealing to investors. This was illustrated in Q3 of 2021, when half of the £3.3bn of new financing raised was capital markets funding.

In response, lenders have taken an innovative approach to encourage low margins despite covenants in documentation. Savills reported that the average rate of margin during 2021 was 2.5%, and traditional lenders are looking to keep margins low in spite of the recent increase of interest rates by the Bank of England. More environmental, social and corporate governance products are becoming available to housing associations. Therefore, traditional funders are aware of the increased competition in financing housing associations. The flurry of mergers has only increased this competition, as the lure of debt capital markets becomes ever more enticing for newly merged and ever larger housing providers.

In conclusion, funders have taken a proactive approach to the recent merger trend within the social housing market, coming up with innovative ways to attract the larger and more streamlined housing associations following their mergers. Traditional lenders have been able to offer low margins with new ESG products whilst capital markets have been able to provide funding with flexibility, resulting in housing associations borrowing more than ever.

It is becoming overwhelmingly clear that more diverse options to funding in the housing market have opened up partly due to increased merger activity and the increased borrowing power that newly merged entities now possess.

However, it is apparent that in the current climate, the merging of housing associations has provided a platform for both funders and associations to progress and succeed.

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