# Hexagon Housing Association

**Board of Management**

***29th September 2015***

**Agenda Item *4***

***Financial Forecast Update***

**Lead Board Member – Debbie Bankole Williams**

**Report from Chief Executive and Finance & IT Director**

#### *Summary*

This paper provides an update to the financial forecast (i.e. our 30 year business plan) in the context of recent Government announcements contained in the summer budget.

The main impact modelled is the reduction in rents (-1% for 3 years) as this is the most material change that we can model with a degree of certainty.

There were other significant changes announced in the summer budget such as Right to Buy and Pay to Stay. Until the Government announce further details about how these two programmes will work in practice, it is very difficult to model the impact on our income. We have therefore made no assumptions at this stage about increased income arising from either Pay to Stay or Right to Buy. In that sense, this update should be seen as the first assessment rather than a final analysis.

The financial modelling outlined in the paper shows how Hexagon can continue to operate within the financial risk appetite set by the Board, despite the reductions in rental income announced in the Summer Budget.

The paper confirms that despite the changes, we can complete the 2015-18 development programme (circa 110 homes over 3 years). We have at this stage assumed no further development from 2018 onwards. As in previous years, we will evaluate our ability to carry on developing in the light of our actual financial performance and further Government announcements concerning what we anticipate will be further reductions to grant available to build new affordable rented homes.

The paper goes on to model a combination of further negative financial factors to help develop a mitigation plan that will come back to the Board at our next meeting in November.

#### *Recommendation*

The Board is recommended to approve the revised financial forecast, and the changes in assumption contained therein.

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| ***1.0*** | ***Introduction*** |
| 1.1 | The Government announced in the Summer Budget that housing association rents would decrease by 1% a year for the next four years. The impact on Hexagon’s finances (£6.4m over the four years to March 2020 alone) were reported to July Board. This meant that, as at July, the financial forecast was not within the Board’s stated financial risk appetite. |
| 1.2 | The HCA require submission of a revised 30 year financial forecast by the end October. |
| 1.3 | DGs have looked at the financial forecast, and considered what changes could be made to bring the organisation back to within the financial risk appetite. These comprise changes in economic assumptions and changes to assumptions about future Board decisions.  |
| 1.4 | It is important to emphasise that the impact of the 4 year rent reduction is cumulative (as rents reduce by -1% over 4 years) but the impact is more gradual in the early years of the plan. The full force of the reduction is felt in 2020 in terms of pressure on our EBIDTAMRI ratio and this area has been the key focus in developing our response. It is also important to emphasise that we will have some time to take a series of decisions to keep the organisation on track financially as part of our annual budget setting process over the next 4 years. This is particularly true in the context of further changes such as Right to Buy and Pay to Stay where we have insufficient information to model the impact in the financial forecast at this early stage.  |
| ***2.0*** | ***Changes to the financial forecast since May 2015*** |
| 2.1 | The financial forecast has been amended for the things we now know:* Rent reductions
* Actual (rather than estimated) interest rate on the AHF bond loan
* Actual (rather than estimated) contribution to the increased pension scheme deficit following the 2014 actuarial valuation
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| 2.2 | Changes to economic assumptions* Routine changes have been made to forecast interest and inflation rates to 2020.
* A significant change has been made to the assumption on interest rates (LIBOR) after 2020. This is because the previous LIBOR rate of 5.8% was calculated using the average difference between interest and inflation rates for 1997 to 2007. This is now increasingly out of date, so we have substituted an assumption of 4.25%, which is what our treasury advisors have recommended for all of their clients. This means that the financial forecast is more realistic.
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| 2.3 | Changes to assumptions about future Board decisions:* Given the reduction in rental income which affects the whole sector, the Board is unlikely to approve salary inflation of CPI +1.7%. The assumption has been reduced to CPI +1%.
* The cyclical painting programme to be reduced so that each rented home is painted every 7 years, rather than every 6 years, from 16/17 to 19/20. The Property Services Director advises that this would have some impact on the appearance of some properties, but limited material impact on the underlying condition.

Each of these decisions will need to be taken as part of each annual budget round, so may not be necessary if savings can be found elsewhere.  |
| 2.4 | The outcome of these changes to the financial forecast is set out in **Appendix A**. The table below shows how they meet the Board’s stated financial risk appetite.

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| **Financial Risk** | **Board’s risk appetite** | **Sept 15 plan** |
| Running out of cash | New facilities to be in place 18 months ahead of need | The plan is fully funded once the planned AHF EIB loan is secured \*. |
| Breaking an interest cover covenant | EBITDAMRI should not fall below 110% in any year of the financial forecast | Minimum EBITDAMRI of 126% forecast in 20/21 |
| Breaking a gearing covenant | Gearing ratio should not rise above 56.7% in any one year of the financial forecast | Maximum HBOS gearing ratio of 55.4% forecast for Mar 2017 |

\*This loan will come to the November Board for approvalOther aspects of the risk appetite (such as capital at risk and meeting the budgeted surplus) are monitored outside the financial forecast. |
| 2.5 | What has not been changed:Either the 15/18 or the Building the Pipeline development programmes, as the financial forecast shows that we can still afford to do these. It should be noted that the remaining “uncommitted” development programme (circa 110 homes over 3 years) is relatively small when compared to our overall housing stock of 4,100 homes, so the impact on overall “lost” income is also relative. This is particularly true for the 15-18 homes that have yet to be built and may be subject to fewer than four annual rent decreases.  The assumption that we will borrow a further £17m from AHF, funded by the EIB, as this is linked to the 15/18 development programmeRight to buy has not been modelled as there is insufficient detail in the public realm to model the impact. Ditto for pay to stay. Our broad understanding from the information received so far is that all additional income, whether from Pay to Stay or from Right to Buy, will either be directed into new supply or repaid to the HCA or GLA. The current assumptions on rent arrears and bad debts have been retained, as we do not know how further cuts to housing benefit and working tax credits will affect our income. The current assumptions are that:* Rent arrears will double by March 2020
* Bad debt losses will increase from 1.32% to 3% for all general needs and supported housing tenancies
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| ***3.0*** | ***Stress testing the plan*** |
| 3.1 | From 15/16 onwards, the Regulator expects registered providers (RPs) to “carry out detailed and robust stress testing against identified risks across a range of scenarios and putting appropriate mitigation strategies in place”. Further guidance in the Code of Practice indicates that RPs should explore those conditions which could lead to failure of the business, even if planned mitigations and controls are successfully implemented. Stress testing should employ scenarios that are designed to assess resilience |
| 3.2 | **If one only thing goes wrong, what breaks the plan, and when?** The first step is to change a single variable (without any mitigating actions), until the plan breaches a covenant. The stress test is timed to start from April 2016, as this is the point when all of the 15/18 programme has been committed (other than 2 small shared ownership schemes). The results are summarised below:

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| **What**  | **What breaks the plan** | **What breaks, and when** |
| LIBOR rates increase sharply at April 2016 | LIBOR rises to 11%, and remains there  | Interest cover drops to 109% in 21/22 and never recovers |
| Salary and maintenance costs increase sharply at April 2016, and continue to do so | Salary/maintenance cost inflation rises to 10% and stays there. | Gearing ratio rises to 62.6% in 2026 and Interest cover drops to 100% in 2026/7. Neither recover. |
| 1% rent reduction continues after April 2020 | 1% rent reductions continue for a further 10 years, before reverting to CPI +1% in 2030/31 | Interest cover drops to 108% in 2041/2 |
| Bad debts in general needs increase from the 1.32% -3% assumed in the plan | Bad debts in general needs rise to 25% throughout the plan | Gearing rises to 61.3% in March 2027 and does not recover |
| House prices drop by in April 2016 and rise only gradually from there.  | House prices drop by 60% and recover only gradually | Interest cover drops to 108% in 2017/18 |
| Mortgage market closes, so cannot sell any properties | Unable to sell any properties (shared ownership, outright sales or voids) after Foxley and Birchfield.This leaves 93 shared ownership units transferred to rent to home buy, and outright sales schemes completed but unsold for 5 years | Does not break the plan, although would have to consider impairment charges and would need a further loan facility of £10m within 2 years and then another £10m by 2026. |
| Deflation, rather than inflation | CPI drops to -10% and stays there, whilst LIBOR stays at 0.25% and salary inflation is 0%. Other costs drop. | Does not break plan, because protected by having to put rents down by only 1% in first four years. Likely that rent settlement would be changed again in this scenario. |

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| 3.3 | Our lenders are keen to know the impact on the plan if rent increases are restricted to CPI from Apr 2020, rather than reverting to CPI +1%.This has been modelled as a separate scenario. The result is that the plan does not break, although interest cover drops to 240% in 2020/21. |
| 3.4 | **What combination of problems breaks the plan?** The next step is to use a combination of the factors to which the plan is the most vulnerable, as follows: • Interest rates rise sharply• Mortgage finance becomes scarce (affecting property sales)• House prices drop• Bad debts arise in shared ownership for the first time, as leaseholders struggle to pay both mortgage payments and rent• Bad debts rise in general needs because Universal Credit struggles to keep up with demand. * The Government imposes a further 5 years of 1% rent reductions,

The following combination has been used:

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| **What**  | **Assumptions modelled** |
| LIBOR rates increase sharply at April 2016 | LIBOR rises to 6% and remains there for 5 years, before dropping to 4.25% |
| Bad debts in general needs increase from the 1.32% -3% assumed in the plan | Bad debts in general needs rise to 7% for 5 years And from 0% to 5% in shared ownership for 5 yearsRent arrears double in first year |
| House prices drop in April 2016 and rise only gradually from there.  | House prices drop by 15% and recover only gradually |
| Mortgage market restricted so takes longer to sell properties | No staircasing for 5 years Asset sales halve40 new shared ownership units take a year to sell40 new shared ownership units transferred to rent to home buy. Outright sales schemes mothballed from completion until sales begin again from April 2021. |
| A further round of rent reductions is imposed  | 1% rent reductions applied to all general needs and supported housing rents for a further five years to 24/25 |

Under this version, *and without any mitigating actions*, we would run out of cash in January 2017. If we could arrange a new £20m loan by then, it would only last until February 2019, after which ever larger loans would be needed. The interest cover ratio does not break (although it dips to 116% in 2020/21). The higher gearing ratio (which rises to 70% if HBOS is repaid) would break in March 2029.  |
| 3.5 | **Possible mitigating actions** It should be emphasised that our first line of attack in meeting the new and more challenging operating environment would be to redouble our efforts in respect of our Value for Money and efficiency agenda. We have a 3 year VFM Strategy and we will continue to push on this agenda. This subject is covered in more detail elsewhere in the agenda. If further savings are required to prevent Hexagon failing to acheive to any of the ratios agreed by the Board in defining its financial risk appetite, it is clear from the discussions held so far at Directors Group that there is a distinction to be made in respect of some of the business critical “must do” workplan items with other more “nice to do” items. To take two clear examples, it would be folly to make too deep a cut to core areas such as rent collection or essential responsive repairs. By the same token, some of the work we do flows directly from our healthy surpluses and this includes some of our Community Investment activities. Whilst no one should be in any doubt as to how we value this work, it is simply a fact that some of this work is not part of our core housing function, nor is it a regulatory requirement. Indeed some of the recent critical press coverage of HA’s has highlighted some of their Community Development activities. What is clear is that in moving forward, the Directors and the Board will need to be nimble and fleet afoot in responding to emerging financial challenges. In so doing, distinguishing between core/essential vs. Desirable but non- essential activities may become increasingly important.  Under this scenario (which is not a forecast, merely a scenario to illustrate what it would take for Hexagon to fail financially) the Board would have to take swift action to prevent the organisation running out of cash and eventually breaking the gearing covenant. This would mean looking at options which would be unpalatable in normal circumstances. The Board could: • Cancel any uncommitted outright sales schemes• Cancel the 2 uncommitted shared ownership schemes• Try to arrange a sale and leaseback of the main office• Reduce stock investment spending • Skip cyclical maintenance for a year• Cut IT capital spend• Increase asset sales in the teeth of a difficult property market • Close the community investment team• Reductions to staffing levels in resident involvement team* Faster reductions to staffing levels in development team

• Sell the sundry debts to a debt factor, and explore whether it is possible to do the same with rent arrears.* Cap salary increases at CPI

A working group meeting to look at developing a mitigation plan in July 2015 was deferred following the Summer budget announcements. It is recommended that this group meet during late October/ early November to prepare a mitigation plan for the November Board meeting.  |
| ***4.0*** | ***Translation to the HCA model*** |
|  | The HCA require a FFR (Financial Forecast Return). If the Board approves the base case business plan recommended in this report, the plan will be translated into the FFR in time for submission by the deadline of 30 October.  |

**Phil Newsam**

**Tom McCormack**