Viability Report - 2009

Spectrum Housing Group L4234

January 2009

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PURPOSE AND INTRODUCTION

The purpose of this report is to provide an assessment of the financial viability of the group, and of its compliance with section 1.1 of the Regulatory Code.

This report is based on:

- Our detailed review of the most recent capacity model for Spectrum Housing Group submitted to the TSA in July 2009.
- The subsidiary business plans published in April 2009.
- The group's latest Corporate Plan, dated 21st July 2009.
- Responses to the TSA's quarterly survey, most recently in October 2009.
- The annual accounts for the year ended 31 March 2009 (unqualified audit report).
- The auditor's management letter for the year ended 31 March 2009 from KPMG.
- Management accounts and financial covenant compliance reports for the six months ended 30th of September 2009.

In making our judgement we have considered the risks the organisation faces, its financial position and the deliverability of its plans.

This reports sets out the findings of our work and communicates our judgement to the group.

The report has been through the internal TSA review process and has been agreed as the TSA's corporate view of the group financial position.

The financial ratios used in the review are explained in detail in the publication "How we Regulate 5: Viability" and this is available from our website, www.tenantservicesauthority.org.

Overview

Spectrum Housing Group owns/manages over 17,000 homes and comprises four main operating subsidiaries, Western Challenge HA, Medina HA, Signpost HA and Signpost Care Partnerships Limited. Its also has two commercial companies, Signpost Homes and

Signpost Services providing private accommodation and property management services. The group operates primarily in the South and South West of England and its mission is, 'to be recognised and respected for providing quality homes and services' as well as 'empowering people, supporting active communities and building better futures.' For the year ended 31st March 2009, the group achieved a surplus of £3.8m on turnover of £85.2m and employed 739 staff.

The Group is an investment partner of the Homes and Communities Agency through its lead of the Source Development Consortium.

EXECUTIVE SUMMARY

Judgement

The Group meets the expectations set out in the Regulatory Code in terms of financial viability, however exposures exist which make it vulnerable to deterioration. This overall viability classification is unchanged from last year.

The group:

- has total loan facilities of £493m, £73m is currently undrawn and provides sufficient financing for at least the next 12 months. It is currently revising its funding strategy and is approaching the market to gauge lender appetite and likely increased funding costs;
- has relatively low ongoing exposure to external asset disposals, although as part of its overall strategy 162 homes in Cornwall (currently owned by Western Challenge) are scheduled for disposal to Ocean Housing during 2011/12. If this sale does not crystalise then Western Challenge's future revenue and capital cashflow projections should be revised, if necessary, to ensure that cashflow liquidity issues do not arise;
- is generating significant amounts of free cash and at group level has substantial financial flexibility to accommodate any unplanned financial weakness;
- has a proactive management team that has made timely decisions to minimise risk exposures;
- 2008-09 audited accounts and the corresponding management letter did not highlight any serious concerns.

There are however a number of challenges;

- particularly in respect of financial covenant compliance across the group. Each of the key group companies, Western Challenge HA, Signpost Housing Association, Signpost Care Partnerships and Medina Housing Association have tailored

financial covenants, based around a combination of interest cover, cashflow cover and gearing. The individual subsidiary financial plans highlight the relative challenges faced by each company in relation to achieving financial covenant compliance. The main theme emerging is of proactive management action being required to ensure financial covenant compliance is satisfactorily achieved. In some cases there is zero contingency and remedial measures are needed mid year if outturn is at variance to plan. Signpost HA's outstanding debt requirements are a good illustration. Funders require debt to be no greater than £146.59m and projected outturn is £146.52m, £72,000 within target. In mitigation the group has a good track record in managing these challenges and has reporting systems in place to manage this key risk and minimise risk exposures;

- the group has stress tested its plans against a number of scenarios and this further highlights the need to appropriately manage subsidiary lender relations and obligations. The impact of a reduction in rents of -1.5% (RPI of -2%) has been modelled by the group. Without any remedial action this would reduce the group operating surplus by almost £1m. In the event September RPI was greater than anticipated and this provides some upside compared with the scenario testing which the group undertook. At the time of writing the group is continuing to undertake further modeling on the overall impact of negative rental growth.

This judgement remains unchanged since our last report dated March 2009, although due to measures adopted by the group its overall financial profile has improved. Table 1 below shows a significant enhancement in EBITDA MRI between approval of the 2008 and 2009 group financial plan. At these levels the group is generating significant amounts of free cash and at group level has substantial financial flexibility to accommodate any unplanned financial weakness.

Table 1

	2009/10	2010/11	2011/12	2012/13
Operating Margin (2008)	26%	28%	29%	28%
Operating margin (2009)	28%	31%	34%	33%
EBITDA MRI (2008)	103%	106%	110%	107%
EBITDA MRI (2009)	148%	143%	153%	145%

Note: At 30 September 2009 the group is outperforming its budget projection for the year.

The improvement in the group's financial profile is mainly attributable to some growth in operating margin as a result of additional efficiencies over and above those previously identified by the group and a reduction in major repair asset management spend following DHS compliance being largely achieved. A fall in debt servicing costs due to lower levels of LIBOR being assumed in the short term also has a material impact.

As highlighted earlier and also in our 2008 Annual Viability Review there is substantial variance between the financial performance of the group's key operating companies. Table 2 illustrates this characteristic of the group's financial profile and emphasises the importance of closely monitoring and reporting on outturn over the course of the financial year.

Table 2

	Western Challenge HA £'000	Medina HA £'000	Signpost HA £'000	Signpost Care Partnerships £'000
2009/10 Surplus after Tax	3,766	950	480	181

In terms of governance around financial performance the Group's Executive Management Team reviews outturn information on a monthly basis and the Board receives and reviews quarterly management information. This includes reporting financial covenant compliance.

Across the group some work remains to be completed in order to meet the Decent Homes Standard. At the 31st of March 2009 Western Challenge had achieved 99% compliance, Medina HA 95% and Signpost HA 91%. The group has set aside financial provision to fund the outstanding works and anticipates meeting the Decent Homes Standard by December 2010. We are monitoring progress on a monthly basis.

Except for Medina Housing Association, which has been granted a five year extension, the group currently expects to meet the requirements of rent restructuring by 2012.

Spectrum Housing Group is the lead partner within the Source Development Partnership. The development of new group homes for rent and shared ownership is concentrated within Western Challenge Housing Association, the group's financially strongest

entity. From April 2011 Western Challenge plans to develop approximately 250 general needs dwellings per annum and between 20 and 50 shared ownership homes per annum. No new development is currently assumed within the other group companies. Relatively high grant rates – in the region of 60 per cent are projected and at these levels may prove challenging to achieve. The Group's Executive Management Team has reiterated that new development needs to be cost neutral at worst (from a revenue perspective) at first let and if this is not likely to be achieved then the scheme will not be approved.

Future Regulatory Engagement

- In light of the above the TSA requires updates on the group's financial position via the quarterly survey, and to be notified of any significant changes to either current performance (and anticipated financial covenant compliance) or future plans if they occur.

Spectrum Housing Group – Medium Term Financial Projections

		Forecast					
	Forecast Period	1	2	3	4	5	6
	Accounts date	2010	2011	2012	2013	2014	2015
	Units						
Turnover	£000's	86,117	89,170	92,606	96,117	96,556	100,266
Operating Surplus	£000's	24,022	27,791	31,425	31,240	32,095	34,455
Surplus/(Loss) on Disposal of Fixed Assets	£000's	949	5,009	945	986	1,028	187
Surplus for Year	£000's	6,621	10,213	8,800	7,628	7,734	7,423
Net Debt	£000's	430,791	422,147	424,896	426,133	430,131	435,249
Total Number of Units	Units	17,970	18,335	18,576	18,840	19,102	19,368
Average Management Costs / Unit	£'s	1,222	1,134	1,115	1,146	1,157	1,173
Average Major Repairs and Maintenance Costs / Unit	£'s	586	535	475	552	558	502
Average Ongoing Repairs and Maintenance Costs / Unit	£'s	508	487	498	514	524	544
Major Repairs and Maintenance Capitalised %	%	8.5%	8.4%	9.3%	9.3%	3.2%	3.8%
Operating Margin	%	27.9%	31.2%	33.9%	32.5%	33.2%	34.4%
Operating Margin MRI	%	26.9%	30.2%	33.0%	31.5%	32.9%	34.0%
EBITDA MRI Interest Cover [Excluding Sales]	Times	148.5%	142.9%	152.6%	144.6%	145.8%	144.6%
EBITDA MRI Interest Cover [Including Sales]	Times	153.5%	164.7%	156.5%	148.5%	149.7%	145.2%
Net Debt / EBITDA	Times	14.76	12.53	11.28	11.36	11.22	10.66
Total Debt per Unit	£000's	25	24	24	24	24	24
Adjusted Net Leverage [Net Debt % Gross Assets]	%	52.5%	50.6%	49.5%	48.3%	47.0%	45.6%

Note: As part of geographic rationalisation the group has identified around 200 homes which will be disposed of externally. This assumption is not reflected in the above table.

APPENDIX 1 – Risk Analysis

Risk	**Management response**	**Residual risk**
Breach in covenants leads to re-pricing of current loans.	Covenant compliance is monitored as part of the group's monthly financial performance reports and quarterly treasury reports. The group's financial plans have been tested against various scenarios. These confirm their relative tightness with regard to financial covenant compliance and consequent importance of management adopting remedial measures if adverse financial variances occur. Management has a good record of managing this risk and has systems and processes in place. Against this background the residual risk is classified medium rather than high.	Medium Covenant compliance is complex given each subsidiary has its own set of requirements. Not unusual in itself but overlaying this is the fact that varying levels of financial strength and consequent outturn subsidiary financial profiles (some strong, some weak) lead to financial covenant challenges at subsidiary level over both the immediate short to medium term. The senior executive management team has identified mitigating strategies. These include inter group transfers which the group has control over.