A BENEFIT TO THE LOCAL COMMUNITY

GORDON IBBOTSON OF FSMD EXPLAINS HOW HOUSING ASSOCIATIONS ARE USING WORKING CAPITAL TECHNIQUES IN THEIR QUEST TO FUND BETTER HOMES FOR LOCAL COMMUNITIES.

This article is based on a recent (mid-2001) financial analysis of a selection of housing associations in England carried out by FSMD, for the Housing Corporation, the regulatory body for registered social landlords (RSLs).

It was based purely on the published annual accounts of the selected RSLs, so it is only possible to comment on the broader structural importance of working capital management, not the day-to-day cashflow dynamics. All the data are averages based on the past three years' accounts.

To get a clearer idea of how it works, we will look at the nature of the various components of working capital and quantify the importance of working capital management in cashflow and balance sheet terms. The article will also set the role of working capital management within the context of the broader financial and treasury management issues in housing associations.

WHAT ARE RSLs? RSLs are not-for-profit organisations with limited equity. Their core business involves buying, maintaining and managing low-cost housing for the benefit of their local communities. Many aspects of the income statement are tightly constrained by the operating environment, including government legislation, and the operating return on total assets averaged only 3.2%, with a top quartile figure of 3.7% and a low quartile figure of 2.5%. By their very nature, traditional RSLs invest heavily in residential properties, both in new build and to buy existing council house stock. They receive government grants which, for this study, contributed 30.2%, on average, to the cash cost of capital expenditure and which represented 53.8% of the written-down balance sheet value of fixed assets. Some RSLs are also involved in service-based care businesses, which have different financial characteristics

After interest payments the retained profit of RSLs is low, despite the general absence of tax and dividend deductions, and new equity is not readily available because of their legal status. Financing of any cashflow deficit has to be by way of borrowing and, as a result, some RSLs are big borrowers to fund additional housing stock expenditure (net of grants) and to meet any operating cashflow deficit. As a general rule, RSLs tend to borrow to the limits of their profitability and cashflow to maximise their housing objectives, in that the more profitable ones tend to spend more on housing stock and therefore borrow more than the less profitable ones. Because of the scale of grant-funded fixed assets and low profitability, cash interest cover rather than balance sheet gearing tends to be the effective constraint on borrowing.

The rate of growth in revenues and assets tends to vary considerably from one housing association to the next. Turnover of the RSLs in this sample grew at 0% to 40% a year, with an average of 9%, so this will result in a variable impact on cashflows through changes in working capital as well as via capex.

WORKING CAPITAL IN THE BALANCE SHEET. The asset components of working capital tend to be rents receivable, other debtors and prepayments, rather than conventional trade debtors. Stocks are of little significance since they are virtually non-existent in RSLs. Most rental income is received in advance, either at the start of the month or mid-month, so trade debtors are generated by overdue rents and these, in turn, may result from delayed benefit payments. The liability components of working capital, therefore, include pre-paid rents as a major item, but also supplier creditors and accrued wages. RSLs would generally have little control over the timing of rent receipts, where a large proportion will depend on benefit payments and they would probably not wish to put undue pressure on tenants in difficulty, given the 'social' objectives of RSLs. They would have more control over payments to suppliers, in particular the 'discretionary' and substantial items of major

TABLE 1
AVERAGE WORKING CAPITAL STRUCTURE OF HOUSING ASSOCIATIONS.

Debtors	250	Creditors	480
Cash	330	Current debt	60
Current assets	580	Current liabilities	540

Current ratio = Quick ratio = 1.07

'THE AVERAGE MOVEMENT IN WORKING CAPITAL LOOKS INSIGNIFICANT RELATIVE TO OTHER COMPONENTS OF CASHFLOW, JUST AS IT DID IN RELATION TO THE TOTAL ASSETS UNDER MANAGEMENT'

refurbishment and capital expenditures, by simply deferring payments.

Total trade-related debtors averaged 10.5% of sales turnover, with quartiles of 17.5% and 6.1%. Total trade-related creditors averaged 20.2% of sales, with quartiles figures of 26.0 and 12.6% . So the 'terms of trade' are equivalent to debtor days of 38 and creditor days of 74. However, in balance sheet terms, total debtors averaged only 2.5% of total assets and total creditors 4.8% of total assets. Balance sheets of traditional RSLs are dominated more so by fixed assets and long-term debt. The resultant ratio of net working assets to sales averaged minus 8.9%, with quartiles of plus 3.4% and minus 13.0%.

The sample reveals that RSLs often have considerable cash balances net of short term debt. On average this represents 2.7% of total assets, with quartiles of 3.7% and 1.6%. RSLs tend not to have large undrawn facilities and they have traditionally been required to maintain a quick ratio of 1:1, so the net creditors and accruals had to be matched by liquid cash balances, plus a bit. Term debt tends to be very long (30 years) and, especially where there has recently been strong growth in borrowing, current maturities of term debt tend to be quite small. *Table 1* summarises the average working capital structure of RSLs.

In practice, the short-term cash/bank position is driven by the interaction of profitability and movements in working capital. Profitability is generally low and therefore the change in net working assets, whether positive or negative, can potentially have a significant impact on the overall pattern of cashflows, as we shall see. This can be a delicate balance.

WORKING CAPITAL IN THE CASHFLOW STATEMENT. The net cashflow before funding for the sample in the study of RSLs was invariably negative because of high interest and capex payments. This is defined as after working capital, interest and capex. On average, the deficit was equivalent to 4% of total assets, with the quartiles at minus 2.1% and minus 5.3% respectively. Some associations, however, had annual cashflow deficits that were greater than 10% of their total assets. These sizeable deficits are demanding in terms of funding and debt management, especially if they are repeated for a number of years.

TABLE 2
MEDIAN CASHFLOW STRUCTURE.

Gross operating cashflow (OCF)	100
Decrease/(Increase) in net working assets	0.8
Net operating cashflow	100.8
Interest paid	(70.8)
Net Capital expenditure	(156.2)
Cashflow before funding	(126.2)
Gross OCF/Interest	*=1.41*
Net OCF/Interest	*=1.42*

At the margin, the cash deficit is caused by acquisition of properties and it is funded by borrowing against these property acquisitions. If the loan-to-value on new properties is the same as on existing premises then leverage will be stable, but for some RSLs the incremental leverage will be much higher, so the cash deficit situation will not be sustainable. The cash generated by net working assets, expressed as a percentage of total assets averaged 0.06%, with a cash consuming top quartile figure of 0.21% and a low quartile figure of minus 0.16%. Across the sample range the figures are insignificant in balance sheet terms, with a maximum of 0.8% cash generated and a minimum of 0.9% cash consumed.

Table 2 illustrates the typical pattern of cashflows for the sample.

The average movement in working capital, therefore, looks insignificant relative to other components of cashflow, just as it did in relation to the total assets under management. The working capital movements would certainly be low compared with a typical manufacturer. The arithmetic average was a 4.2% contribution to gross operating cashflow. However, at one extreme of the sample, the change in working capital could contribute between 20% and 170% extra to gross operating cashflow (OCF). At the other, it could consume 20% to 65% of gross OCF. Of the sample of 38 RSLs, by coincidence, 19 generated cash from changes in working capital and 19 consumed cash only.

WORKING CAPITAL MANAGEMENT, DEBT SERVICING AND COVENANTS. On average for the sample, as we have seen, a relatively small amount of cash was generated by changes in working capital. *Table 2* shows that, typically, the cash interest cover increased slightly from 1.41 before working capital to 1.42 after working capital. The average data, however, conceals some interesting and apparently systematic variations.

For the 19 RSLs in which working capital changes consumed cash, the cash interest cover before working capital tended to be relatively high, averaging 1.61 times. These associations tended to have higher annual growth in turnover and a higher ratio of net working assets to sales, so it is perhaps not surprising that working capital consumed cash. After the effect of working capital changes, the cover ratio was reduced by 16.6% to 1.33 times. Working capital consumed the equivalent of 27.8% of the interest cost.

The 19 RSLs in which working capital changes generated cash had a significantly lower average cash cover ratio of 1.22 before working capital changes. These housing associations tended to have both lower growth rates and working capital to sales ratios. After working capital changes, the cash cover increased by 24.9% to 1.41, finishing higher than the other half of the sample. Cash from working capital effectively paid 18.3% of the interest cost. This illustrates that necessity, once again, seems to be the mother of invention.

To examine this apparent relationship from another perspective, the sample was re-sorted into the 19 associations with the highest cash cover before working capital changes and the remaining 19 with the lowest cash cover.

The impact of working capital changes on cash interest cover levels is well demonstrated in *Table 3*. Further statistical analysis showed that, for the low cover RSLs, the level of cover not only increased on average but also became less variable across the

TABLE 3
COVER RATIOS AND WORKING CAPITAL MANAGEMENT.

	Average Cash Cover Ratio (before)	Average Cash Cover Ratio (after)	Effect of Working Capital on Cash Cover	Growth in Total Assets%	Net Working Assets Sales
High cash cover RSLs	1.80	1.68	-5.8%	15.3%	-3.9%
Low cash cover RSLs	1.04	1.06	+14.1%	11.9%	-10.4%

NB Because of arithmetic averaging of ratios the figures in the first three columns may appear to be numerically inconsistent.

sample. For the high cash cover RSLs working capital changes tended to consume cash, the average cover reduced and it also became more variable. Compared with the low cash cover associations, they had higher sales growth and lower working capital ratios. This combination would normally generate cash, though less than for the other half of the sample. Therefore, the active management of working capital seems to have had a differential effect between the two groups. It is almost certainly the nearness to cash cover covenants in RSLs' loan documentation that provides the stimulus to squeeze working capital. If the cover level is more comfortable, there seems less incentive to make the effort.

The figures in *Table 4*, which summarises correlations between key variables, show a reasonable correlation between working capital changes and gross cash interest cover, as discussed above. The change in working capital might be expected to correlate well with sales growth and the ratio of working capital to sales. There is some support for the first proposition, in that when sales are growing cash tends to be consumed, but the relationship is not very strong. The change in net working assets does not correlate at all with the working capital ratio, nor with profitability. Finally, there is also no correlation with cash cover after working capital changes.

TABLE 4
SUMMARY OF CORRELATIONS BETWEEN CASH FROM WORKING CAPITAL AND SELECTED VARIABLES.

	Selected Variable	Correlation Coefficient
Some relationship	Gross cashflow interest cover	(0.52)
	Sales growth	(0.32)
No relationship	Gearing	(0.12)
	Net working assets % sales	0.04
	PBIT % Total assets	(0.02)
	Net cashflow interest cover	0.01

CASH CONTROL. First, it must be noted that working capital management is a relatively minor topic in the financial management of RSLs. Debt management, new projects and business planning have a much greater importance. Working capital management in housing associations seems to be responsive to the degree of margin – or lack of it – between gross operating cashflow and interest payable. This varies considerable from one association to another. If cash cover before working capital changes is low then, despite the difficulties mentioned earlier, cash tends to be more tightly controlled, probably by stretching creditors and easing off growth. Therefore, cash is generated from working capital to ensure that covenants are not breached.

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