INFLATION AND THE IMPACT ON FUNDING

‘CARE THOUGHTS’ SEPTEMBER 2021

1. Introduction

Over the last two months there has been a subtle shift in the attitude to inflation amongst both investors and the central banks.

Initially rising inflation was seen as both a good thing and strictly temporary as the global economy comes out of lockdown – an inevitable and healthy by-product of recovery from the dramatic falls in Gross Domestic Product that took place in 2020 and early 2021.

However, in June/July attitudes began to change. Supply constraints translated into sharp price increases with a rapid acceleration in both CPI and RPI rates. This is shown in the chart below:

	2020		2021							
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
CPI	0.3%	0.6%	0.7%	0.4%	0.7%	1.5%	2.1%	2.5%	2%	3.2%
RPI	0.9%	1.2%	1.4%	1.4%	1.5%	2.9%	3.3%	3.9%	3.8%	4.8%

At the same time concerns are growing that the rise in inflation may prove far from temporary unless Central Banks start to take corrective action by phasing out Quantitative Easing and raising interest rates.

So far, with the exception of Norway and Canada, this has only translated in a shift in the mood music emanating from the Central Banks, accompanied by slight acceleration in the timing of expected interest rate rises, generally now focused on 2023 and 2024.

But for those of us with memories of previous upticks in inflation, this appears dangerously complacent.

In any case, it raises the question of how businesses should adjust funding plans to address the risk of inflation, now expected to be at over 4% in the UK for the first half of 2022 and decline only slowly thereafter.

2. Business plans and the cost of debt

At Allia C&C we regularly review business plan assumptions for the next 3-5 years to ensure we are providing appropriate advice on funding strategy and the mix of fixed and floating rate debt.

In the table below we set out our assumptions on inflation, which are now at the more cautious end of expectations. They show a situation where CPI and RPI rise sharply in 2022 before falling back again to a steady state of 2.00% and 3.00% respectively in 2025.

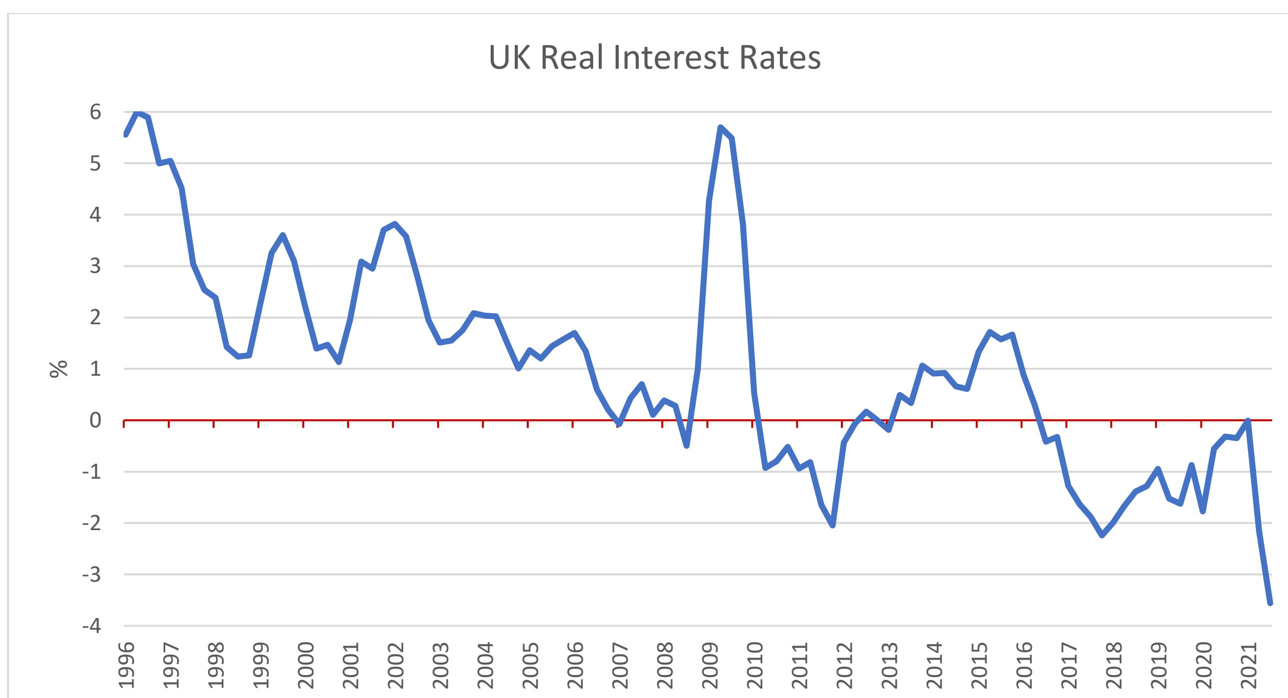
The figures below represent the average for each financial year – though we are happy to provide quarter by quarter estimates if this is of interest.

Inflation	2021/2022	2022/2023	2023/2024	2024 thereafter
CPI	3.25%	2.88%	2.06%	2.00%
RPI	4.23%	3.88%	3.06%	3.00%

While these figures seem unremarkable by comparison with previous hikes in inflation, it is the implication for interest rates that is worrying.

Over the last two years we have become accustomed to low or negative real rates of interest. This reflects an accommodative approach to monetary policy during lockdown as Central Banks sought to counter any negative impact on growth by pumping money into the economy.

Yet, unsurprisingly, periods of negative real rates are relatively rare and usually only last for a short period of time. This is shown in the chart below which tracks RPI against the 30 year gilt:

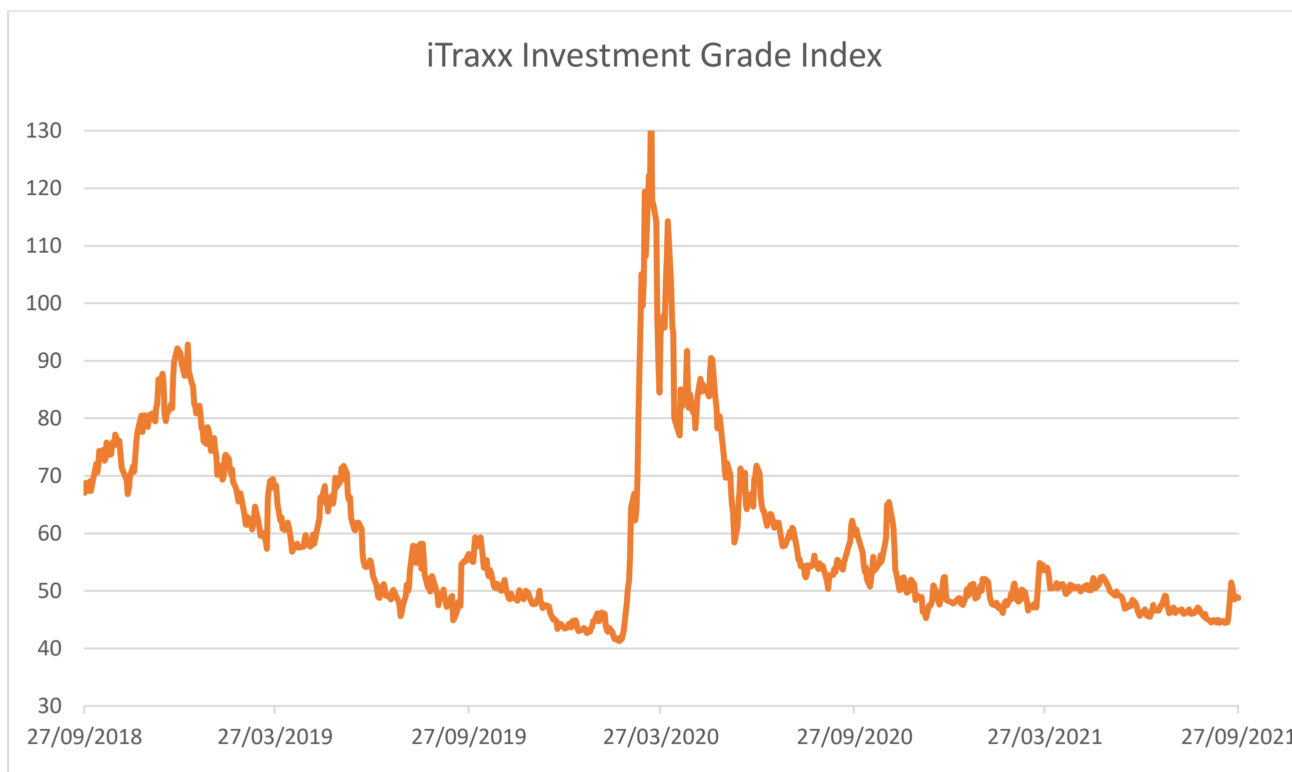


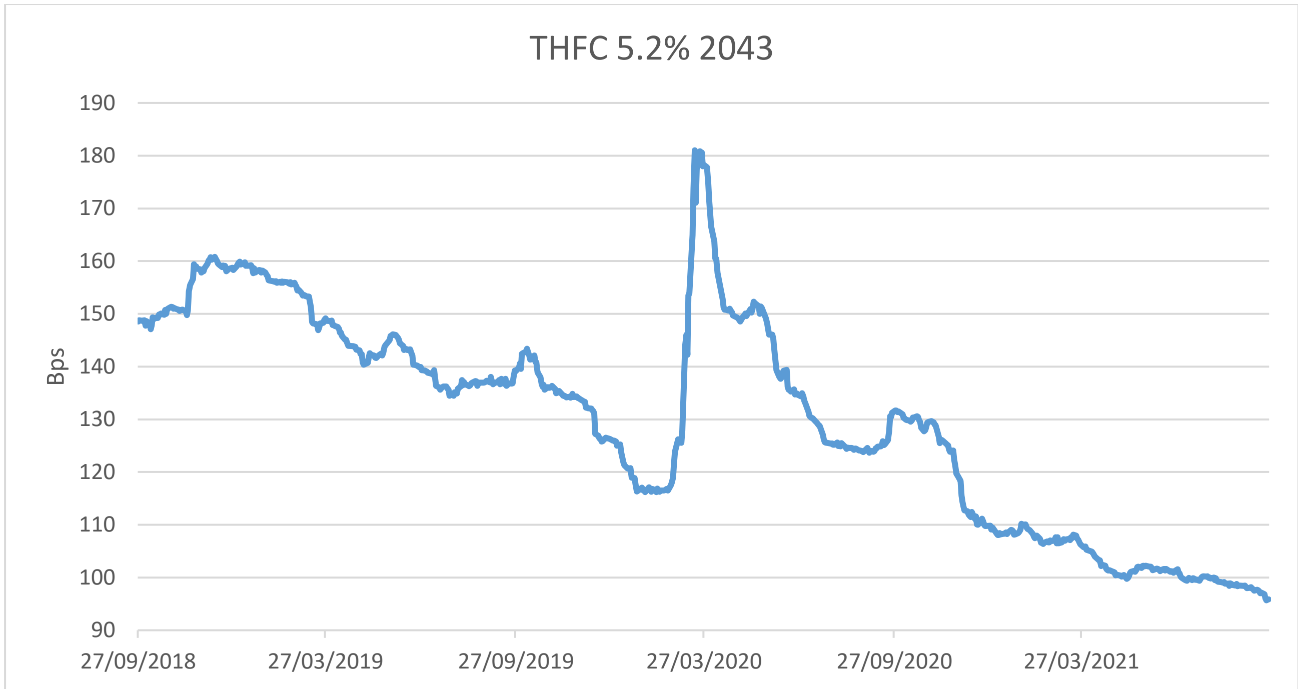
If, for example, we assume that in the long term the economy reverts to real rates of between ½ and 1% depending on maturity, this produces the following outcomes:

	2021/2022	2022/2023	2023/2024	2024 thereafter
Base Rate	0.10%	0.63%	1.44%	2.25%
3 month Sonia	0.08%	0.75%	1.65%	2.25%
10 year gilt	1.00%	1.50%	2.15%	2.50%
30 year gilt	1.61%	2.88%	3.00%	3.00%

It is necessary to add the margin to arrive at the full cost of borrowing. In a period of high Government borrowing, any policy designed to tighten monetary policy is likely to lead to a widening in lending margins on bank and wholesale lending in the financial markets.

Over the last 2-3 years these have narrowed – a tendency best demonstrated in the iTraxx credit index for Investment Grade debt set out below and most clearly demonstrated by the performance of the Housing Association aggregator THFC, which has over £2.0bn outstanding in various issues.





At present the market is awash with liquidity, making both banks and institutional investors keen to lend.

If interest rates rise to combat inflation, this will change. It suggests that someone borrowing from a bank at a margin of 1.5% now, should assume a margin of 2.0% – 2.5% in two years' time, with the risk that lenders' approach to maturities and covenants could become progressively less accommodating.

Meanwhile margins for Investment Grade borrowers (rated at BBB or better) in the bond market could increase by 50% while margins for weaker credits would rise further.

To place this in context, this only takes margins back to pre- 2019 levels in the public bond market.

The sole exception to this is likely to be on retail eligible bonds like RCB, where investors are often looking for a minimum level of income. So while yields on retail eligible bonds have failed to fall in line with the wholesale market, we anticipate that as rates increase, yield expectations will lag, and these spreads will largely remain unchanged.

This has the following implications for the all-in cost of borrowing:

	2021/2022	2022/2023	2023/2024	2024 thereafter
5 year bank debt	1.60%	2.75%	3.65%	4.25%
10 year bond	2.00%	2.75%	3.65%	4.25%
10 year retail bond	3.50%	3.75%	4.00%	4.25%

3. So what is to be done?

We think for Care Home and retirement living operators this poses a real challenge.

While Government is now focusing on the funding issues affecting the sector, the approach has been long on rhetoric and short on any specific actions to improve the funding of provision, whether through regulation or support on the payment of fees.

At the same time, the sector faces the problem that when the rate of inflation is rising, fee increases are likely to lag any rise in costs– placing a further and unwelcome squeeze on margins.

It raises a number of issues:

A. Inflation linked funding

There is considerable pressure to enter into sale and leasebacks as a mechanism for the long term funding of new care homes. Rents are generally linked to inflation – with real rates (i.e. prior to inflation adjustment) set at between 3.5% and 5.5%.

While "caps and collars" on the rate of inflation are often available ranging from 0 to 3% or 5% per annum, a sustained rise in inflation will often result in rents outstripping market levels to reach unaffordable rates after a relatively short period of time. For instance, if inflation rises to between 3 to 4% for any sustained period of time, this will involve a rise in the costs to 6.5 – 9.5% per annum, cumulative over the period.

The agreements are extremely expensive to unwind (initially representing a premium to capital cost of up to 80%) thus limiting the flexibility of the business to respond to any problem on earnings. They also apply pressure at a time when performance is already likely to be under stress from rising costs elsewhere.

This is the history of Southern Cross which failed the last time the economy faced a sustained round of monetary tightening which was also accompanied by a failure of Government to raise payments in line or ahead of rising costs.

B. Fixed rate debt

While the cost of borrowing fixed rate debt is somewhat higher than floating rate debt at present, it provides the business with insurance against the impact of rising interest rates at a time when all other costs will also be rising.

Fixing the cost of debt over the medium term at 3.5 – 4.0% is likely to provide significant support to the business as inflation increases and the cost of floating debt goes up.

Periods of low cost fixed rate debt are relatively rare and generally occur at times of lax monetary policy, ahead of a tightening. This is recognised by larger seasoned borrowers which is why there has been a record level of fixed rate borrowing by corporates in the Sterling market over the last 2 years.

Now is therefore an opportune time to consider the pros and cons of fixing a proportion of your debt.

C. The maturity of your debt

There is a natural benefit to extending the maturity of your borrowing when the debt market is at its most competitive – particularly if it does not involve significant additional expense.

An inflationary cycle will generally last for a number of years (? between 3 – 5). Extending the maturity on part of your borrowing to between 7 and 10 years allows you to ride out the cycle and match any refinancing to periods of strong lender appetite.

D. Security and covenants

There has been a natural tendency of banks to tighten security covenants on new debt for care home operators as a response to the pressure they faced during Covid. In particular there has been a renewed focus on Debt to EBITDA covenants.

This makes borrowers vulnerable to any short term pressure on earnings. While banks were amenable to providing waivers during the pandemic, it still left businesses dependent on the banks' good will – particularly during a period when there were no alternative sources of funding easily available.

There is a real cost to the business of providing covenants. This should be factored into any decision. It extends beyond simple stress tests to the recognition that there is always the risk of the unexpected.

This also applies to the request for security. LTV covenants come with the requirement for regular revaluations. Any decline in the valuations (almost inevitable if earnings are placed under pressure by rising inflation) will clearly limit the capacity of the business to raise additional debt.

E. Diversifying the sources of funding

Finally, there is the issue of diversifying sources of funding. Many care home operators are dependent on a relationship with a single lender. This often comes with a close and pro-active relationship but if there is a change in relationship officer or policy, this can leave the borrower with limited options.

Broadening the sources of funding to include private placements or the public bond market (including through intermediaries like RCB) provides a useful safety valve for the business.

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