Empire building? Analysing the drivers towards mega-mergers in the English housing association sector

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Structure of Presentation

Research focus

• Analyzing external drivers and managerial motivations behind mega-mergers in English not-for-profit housing Association sector
• Draw on business theory of mergers
• Re-examine theory in context of the sector
• Research methods
• Emerging findings
• Preliminary conclusions and policy implications
Critical juncture for Housing Associations

- Fundamental changes:
  - to the economic climate
  - government regulations
  - investment funding
- New strategies to ensure their long-term survival
- A wave of mega-mergers
- Becoming the largest volume housing builders in the country!
Operating environment for mergers

- Key external drivers that make mergers attractive option common to all firms e.g.
  - Regulatory changes and political developments (Thelen 2009)
  - Changes in the financial market (Rhodes-Kropf and Viswanathan 2004)
- ‘Positioning acquisitions’ in response to a regime shift so that individual businesses ensure long-term legitimacy and survival (Gorton et al 2009)
- Over time mergers tend to come in waves (Toxvaerd 2008)
  - Institutional entrepreneurs take lead (Garud et al 2007)

*Race for firm size*
Organisational motivations

• *Maximise shareholder value*

Increase business performance and profit-making (Morek et al 1990)

• *Efficiency benefits through positive synergy gains*

Financial efficiency through reduced cost of capital (Lewellen 1971)
Operating efficiency through economies of scale (Scherer 1988)
Increase market share (Masksimovic & Philips 2001)
Access to new technologies & markets (Manne 1965)

• *Managerial benefits*

Managers may seek their personal objectives (Morck et al 1990)
Market conditions:
- Industry regulation
- Social responsibility
- Custom and embedded practices

Industry conditions:
- Objectives
- Business model
- Core markets

Company conditions:
- Financing
- Efficiency
- Management

Decision maker conditions:
- Compensation maximization
- Empire building

Market environment:
- Interest rates
- Business cycle
- Economic growth
- Capital availability
- Competition

Strategic:
- Self interest:
# The English HA sector

<table>
<thead>
<tr>
<th>Core activity</th>
<th>Providing affordable and social housing.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business model</td>
<td>Based on social housing lettings but increasingly supported by commercial activities.</td>
</tr>
<tr>
<td>Profit</td>
<td>Surplus reinvested into core activities</td>
</tr>
<tr>
<td>Financing</td>
<td>Government grants, retained profits and private loans.</td>
</tr>
<tr>
<td>Loan security</td>
<td>Government guaranteed rents and social housing assets.</td>
</tr>
<tr>
<td>Credit ratings</td>
<td>A (varies)</td>
</tr>
<tr>
<td>Regulation</td>
<td>Regulated by Homes and Community agency</td>
</tr>
<tr>
<td>Voting rights</td>
<td>Public can apply to have voting rights but do not receive dividends.</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Board members are recruited by shareholders and managers.</td>
</tr>
<tr>
<td>Tax optimisation</td>
<td>Taxable subsidiaries use gift aid to minimize tax at group level</td>
</tr>
</tbody>
</table>
Contemporary shake up of English HA sector

Media hostility

- ‘True villains of housing crisis’ (Channel 4 News 23/7/15)
- ‘Public sector lethargy and private sector greed’ (The Spectator, 25/7/15)
- ‘Sleeping giants’ (The Economist, 21/11/15)
- ‘High salary, low performance - £350,000 salary for Britain’s worst housing chiefs’ (The Times, 18/3/16)

Government hostility

- ‘There has not been much pressure on the sector to be particularly efficient in recent years’ (Osborne, HoC, 8/9/15)
- ‘Part of the public sector that haven’t been through efficiencies, haven’t improved their performance and it is about time they did’ (Cameron, HoC, 15/9/15)
- Steep cuts in government grants for new build
- Government stipulates 1% rent cuts per annum next 4 years

- Self financing/ Efficiency agenda
Organisational motivations

- Debt has become an increasingly popular method of funding expansion in the HA sector (Wainwright and Manville 2017).

- To attract investment from institutional funders, individual HAs require high ratings from credit rating agencies (Manzi & Morrison 2017).

- Economies of scale, including shared and integrated back-office functions and consequent projected costs savings (Bortel et al 2010, HNQ 2016).

- Yet, the government regulatory body, Homes and Communities Agency has found NO statistical correlation between size of HA and efficiency in terms of unit costs (HCA 2016, p.18).
Research Methods

• Case study analysis of the six London-based HAs undergone mergers (2016/17):
  o Affinity Sutton and Circle HA (Clarion Group) (>125,000 units)
  o London & Quadrant (L&Q) and East Thames (>90,000 units)
  o Family Mosaic and Peabody (>55,000 units)

• All merger deals examined in the context of the analytical framework and supported with evidence from interviews with key senior executive decision makers & financial accounts of all analysed entities
# Key data on paired HAs

<table>
<thead>
<tr>
<th></th>
<th>Affinity Sutton</th>
<th>Circle</th>
<th>East Thames</th>
<th>London &amp; Quadrant</th>
<th>Family Mosaic</th>
<th>Peabody Trust</th>
<th>England total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Size</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total fixed assets</td>
<td>£2,939,629</td>
<td>£3,958,700</td>
<td>£1,108,059</td>
<td>£7,747,254</td>
<td>£2,364,306</td>
<td>£3,032,867</td>
<td>£143,223,847</td>
</tr>
<tr>
<td>Turnover</td>
<td>£386,423</td>
<td>£439,200</td>
<td>£128,723</td>
<td>£719,788</td>
<td>£265,640</td>
<td>£351,979</td>
<td>£19,979,660</td>
</tr>
<tr>
<td>Closing social housing units managed</td>
<td>58,679</td>
<td>62,647</td>
<td>13,577</td>
<td>63,604</td>
<td>24,878</td>
<td>24,598</td>
<td>274,4785</td>
</tr>
<tr>
<td>CEO compensation</td>
<td>£320,933</td>
<td>£239,109</td>
<td>£155,000</td>
<td>£355,105</td>
<td>£220,000</td>
<td>£223,060</td>
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<tr>
<td><strong>Operations</strong></td>
<td></td>
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<tr>
<td>Surplus for the period</td>
<td>£144,779</td>
<td>£85,800</td>
<td>£28,036</td>
<td>£273,535</td>
<td>£73,486</td>
<td>£122,118</td>
<td>£3,341,367</td>
</tr>
<tr>
<td>Headline Social Housing Costs per Unit</td>
<td>3.46</td>
<td>4.19</td>
<td>3.94</td>
<td>3.32</td>
<td>6.86</td>
<td>5.79</td>
<td>3.97</td>
</tr>
<tr>
<td>Operating Ratio</td>
<td>51%</td>
<td>64%</td>
<td>59%</td>
<td>35%</td>
<td>61%</td>
<td>42%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Financing</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Gearing ratio</td>
<td>40%</td>
<td>53%</td>
<td>53%</td>
<td>27%</td>
<td>30%</td>
<td>36%</td>
<td>45%</td>
</tr>
<tr>
<td>Credit rating pre/post merger (Moody's)</td>
<td>Aa3/A2</td>
<td>A2/A2</td>
<td>A3/A2</td>
<td>A1/A2</td>
<td>A1</td>
<td>A3</td>
<td></td>
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<tr>
<td><strong>Diversification</strong></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Surplus from non-SH activity</td>
<td>8%</td>
<td>23%</td>
<td>11%</td>
<td>21%</td>
<td>24%</td>
<td>30%</td>
<td>15%</td>
</tr>
<tr>
<td>Non SH - Market rent - Surplus</td>
<td>£660</td>
<td>£8,000</td>
<td>£0</td>
<td>£9,014</td>
<td>£0</td>
<td>£2,989</td>
<td>£96,937</td>
</tr>
<tr>
<td>Social properties added</td>
<td>1,015</td>
<td>450</td>
<td>-214</td>
<td>419</td>
<td>504</td>
<td>743</td>
<td>51,333</td>
</tr>
</tbody>
</table>

(Source: Authors compiled from HCA 2017, individual financial accounts, Inside Housing CEO salary survey 2016)
Political imperative to be more self-financing & efficient

“Challenged by government to sweat our assets – claims not doing enough”

“We are seen as part of the problem YET we want to be part of the solution”

“Better together”

➢ Re-positioning/ staying relevant
Managerial motivations

Size

- Circle is 35% bigger than Affinity Sutton = merger of equals
- Peabody is 28% bigger than FM = merger of equals
- L&Q is 7 times as large as East Thames = take over merger

Financial efficiency

- Take risk of credit rating being downgraded
- Yet opportunity to access additional debt at better rates
- Borrow more in order to increase development output
Managerial motivations cont.

**Operational efficiencies**

- Forced to make cost savings due to Government’s 1% rent cuts p.a.
- Large differences between HAs in operating ratios – cost per unit
- Ability to introduce IT 24/7 service delivery
- Back office savings YET local accountability sacrificed?

**Exploit new business opportunities**

- Increase exposure e.g. to market rental housing (Morrison 2016a)
- Ability to share risk & offers greater options
- ‘Flex’ tenure to reduce over-exposure to market sales
Managerial motivations cont.

**Extend market share**

- Ability to extend geographically e.g.
  - L&Q extends its reach into East London through acquiring East Thames
  - Family Mosaic benefit from Peabody owning Thamesmead (London’s largest development site)

- Increase asset base more quickly than through organic growth

**Managerial motives**

- No shareholder accountability
- Reputational damage once CEO salaries announced
- Acting in best interests of organisation & society – long term stewardship
- Over-estimating merger benefits – common across all sectors…
Preliminary Conclusions & policy implications

• Mergers in the HA are not new

• YET new breed of super-sized HAs - ‘institutional entrepreneurs’ (Garud et al 2007)

• Ensure legitimacy & meet government expectations
  - More self financing, Increased efficiency & maximize development capacity
  - YET to be proven & takes time to embed organisational & cultural change..

• With size comes status and take control of futures
  - Potential to demand greater freedoms and challenge government

• Institutional isomorphism – as others fear being left behind

  ➢ At expense of local accountability & social purpose?