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Credit FAQ:

Why U.K. University Student Accommodation Projects Are Satisfying Investor Appetite For Long-Term Infrastructure Debt

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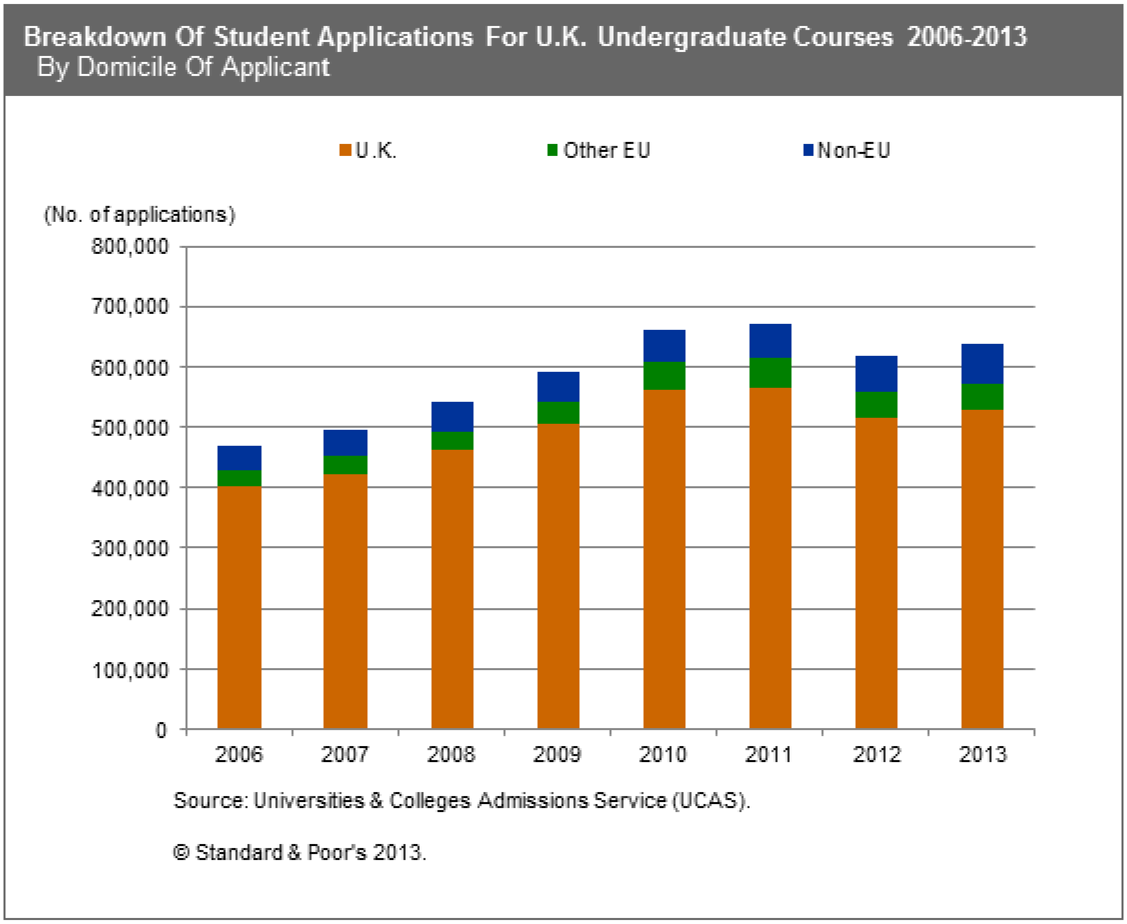
The private financing of student accommodation--or so-called "halls of residence"--in the U.K. is growing at a frantic pace. These projects are largely being funded through highly leveraged financing structures with long-term debt tenors that mirror the lengthy head leases, backed by strong support from the host university. Despite the recent rise in tuition fees, together with reforms to student number controls in the higher education system, the U.K. student accommodation market remains significantly undersupplied. And growing demand from overseas students means there is also an increasing international student demographic in U.K. universities taking up a larger slice of the new, often high-tech, purpose-built halls of residence.

The U.K. is the second-most popular student destination in the world after the U.S. and demand from international students continues to increase. Applications from overseas students rose 8.5% between 2011 and 2012, and 6.0% between 2012 and 2013, according to the Universities & Colleges Admissions Service (UCAS; see chart 1). That said, market perceptions that the U.K. is becoming less welcoming to foreign students, or increased restrictions on student visas, could dampen that growth. Similarly, ongoing education reforms (particularly in respect of A-levels and controls on the number of students) could introduce more volatility around the number of domestic students attending certain universities, with a consequent effect on volume risk for accommodation projects (see "U.K. Higher Education Reforms Pose University Challenge," published June 25, 2013, on RatingsDirect). Student accommodation projects also face other challenges, including the prospect of having to increase annual rental levels in line with inflation as well as maintain a competitive offering vis-à-vis the private rented sector.

Chart 1



In this Credit FAQ, Standard & Poor's Ratings Services addresses some of the likely questions from investors regarding how we assess the credit quality of the U.K. student accommodation sector and our views on future trends for related project transactions.

Frequently Asked Questions:

Why has bond issuance in the U.K. student accommodation sector shot up recently?

Student accommodation in the U.K. is already an established asset class. Historically, supply has been driven by higher student demand, the recruitment objectives of universities that compete against each other on their student offering, as well as increasing investor interest. Up until recently, most of the new-build and refurbishment activity has been funded with bank debt and equity and has not included estate or facilities management (FM) outsourcing to the private sector. Today, we see more private finance initiative (PFI)-style student accommodation transactions in which construction, operations and maintenance, and lifecycle risks are transferred to a third party developer that also raises the project finance. Moreover, these transactions are being financed by long-dated bond issues in the capital markets, sometimes as long as 40 years.

So far in 2013, we have rated the debt of three new U.K. student accommodation transactions: £382 million related to

UPP Bond 1 Issuer PLC; £143.5 million related to ULivingAtHertfordshire, and most recently the issuance of £63 million linked to Holyrood Student Accommodation Plc, which closed on July 30, 2013. (See Appendix for a breakdown of our rated U.K. student accommodation projects.)

What does Standard & Poor's consider to be the main credit risks in student accommodation projects?

We believe the business risk of these projects to be higher than availability-based U.K. PFI projects (such as those for schools and hospitals), since they are typically exposed to both volume and price risk. This is despite the current strong performances and positive forecasts for both occupancy rates and rental levels for the sector in general. In our view, price risk is slightly higher than for other projects, with tariffs contractually indexed to inflation. There is no guarantee that rental levels will continue to rise at or above the retail price index (RPI) during the entire project's life, as this depends on economic and market conditions. There is also the risk of contractually set rental level increases materially affecting demand, possibly leading to a reduction of occupancy or a decision between the university and the project company (ProjectCo) to forgo contractual obligations and not increase rents in order to maintain occupancy levels. This exposure to volume risk could increase further through tightening U.K. entry visa requirements and ongoing education reform that has already led to significant increases in tuition fees. These factors, along with a rapidly growing and highly competitive international higher education market, could reduce student demand in the U.K., especially for second-tier universities.

We consider exposure to the credit risk of the universities as an important factor in rating student accommodation projects because the universities usually retain student credit and void risk. Furthermore, there's a strong correlation between demand for university places and occupancy of the project's assets, leading to a high interdependency between the two. Consequently, we look closely at the expected long-term student demand for the sponsoring institution. It's worth noting, though, that our assessment of corresponding universities has not yet posed a cap on a project's Standard & Poor's underlying rating (SPUR) in transactions that we've rated recently.

In addition, student accommodation projects are exposed to some concentration risk. Projects will be characterized either by a single asset or a lack of student diversification, concentrating mainly in undergraduates or postgraduates from one higher education institution. However, this is not always the case: UPP Bond 1 Issuer, for example, benefits from revenue sources from six different universities with a mixture of undergraduate, postgraduate, and overseas students and full cross-collateralization, allowing cash pooling.

The risk of operating and maintaining student accommodation facilities is low and, in our view, even lower than the O&M risk associated with U.K. PFI schools and hospitals, where the interface with patients or pupils can be more challenging.

Is it still possible for student accommodation projects with construction risk to achieve investment-grade underlying ratings?

Standard & Poor's has recently rated a £143.5 million bond related to ULiving@Hertfordshire at 'A-/Stable' and a £63 million bond linked to Holyrood Student Accommodation at 'BBB/Stable' (SPUR), both projects being pre-construction completion. In student accommodation transactions, we tend to see fixed-price, date certain, turnkey construction contracts where we believe construction risk to be limited. This is because the building design and refurbishment works are relatively simple, with mostly green-field sites and traditional construction techniques.

Furthermore, both the aforementioned projects benefit from no revenue risk during the construction period because the universities will guarantee rental income during this phase.

For a project with construction risk to attain an investment-grade rating would in our view largely depend on the ability of the transaction structure to permit the full and timely payment of scheduled debt service on the rated obligation under a relatively likely downside construction scenario. This would be based on our own experience of similar projects under construction as well as the opinion of an independent technical advisor.

More specifically, investment-grade rated projects typically comprise, but are not limited to, a robust structure accompanied by a construction credit support package. The package could be, for example, an on-demand, unconditional and irrevocable letter of credit or performance bond provided by a financial institution with a minimum rating above the project rating. These institutions cover estimated replacement costs associated with an insolvent or failing construction contractor, delays, or costs overruns. This type of third-party construction liquidity package typically mitigates a potentially constraining factor of a weak construction counterparty. Furthermore, investment-grade rated projects include experienced contractors carrying out the required works, with the periods allowed for each construction activity reasonable and achievable for the design and volume of work. (For more details on our construction counterparty criteria, see "Project Finance Construction and Operations Counterparty Methodology," published Dec. 20, 2011).

How have the student accommodation projects rated by Standard & Poor's sought to mitigate price and volume risks?

We've seen different types of structures put in place to partially diminish key risks. Generally the university provides some support to the transaction, by way of occupancy guarantees or minimum rental payments, thereby providing support for project cash flows. Furthermore, the financial risk profile of the project is generally dependent more on the business risk profile of the university, its ability to maintain and grow student demand, and on the availability of alternative accommodation, rather than solely on the financial risk profile of the university and its ability to meet its own obligations on a timely basis.

On Catalyst Higher Education (Sheffield) PLC for example, the University of Sheffield (UoS) guarantees part of the project income through the minimum rental payment, currently set at a level equivalent to 85% occupancy from 2011 to 2020 (falling to 80% in 2021 and 69% in 2045). ProjectCo receives all of its revenues from the UoS and is therefore only exposed to the credit risk of the university. As a result, we believe this provides an incentive for the university to keep occupancy high through an income-sharing mechanism and in essence partially mitigates volume and price risk. Another case where we see a high level of interdependence with the university is on Keele Residential Funding PLC. Keele University is responsible for setting student rents and providing soft FM, hard FM, and all lifecycle obligations. It is also the main sponsor of the project, with 99.7% participation. In the more recently rated Holyrood Student Accommodation transaction, the University of Edinburgh has access to its first-year postgraduate and overseas students before they are introduced to private accommodation providers. It will market its facilities on the same basis as its own postgraduate accommodation--that is, there will be no unfair advantage given by the university to its own accommodation stock relative to that operated by ProjectCo.

We've seen that volume risk has been partially mitigated through a variety of mechanisms on rated transactions.

Starting from strong demand for university places and a high student per bed ratio, to better room facilities, location, or lower rent levels compared with the market competition. We take into consideration whether the project is located off-campus or on-campus, where further developments are usually limited. Restrictive covenants exist on some transactions, with the purpose of limiting competing stock being owned by the university and establishing a predictable volume of demand for the rooms. However, the risk of further private developments in a university's surroundings typically persists, potentially leading to lower demand in the medium to long term.

Regarding the mitigation of price risk, again we've seen a variety of mechanisms used to reduce exposure. A gain-sharing mechanism and rent pooling, for example, have been put in place to encourage the University of Hertfordshire to approve rent increases in the ULiving@Hertfordshire transaction. For the Holyrood project, starting rents are significantly below (minus 15%) comparable student accommodation developments in the city, placing the project in a strong position to compete for students. The transaction's rent-setting mechanism allows for the vast majority of operational cost increases as a result of inflation to be passed on through rent increases.

How does Standard & Poor's view the linkage between the credit quality of the sponsoring university and the student accommodation project?

The sponsoring university is usually in charge of collecting rents in advance and pays them to ProjectCo on set dates, assuming credit and void risk on students, meaning ProjectCo assumes the university's credit risk. In addition, occupancy levels on student accommodation ultimately depend on student demand for the university itself. Therefore, the university's credit quality is an important factor in the transaction. We typically see strong partnerships between both parties, including, among others, capital contributions; restrictive covenants limiting future competing stock; and marketing and allocating students on the project's rooms on an equal basis to the university's own stock. Furthermore, the university in some cases undertakes maintenance and refurbishments on the project's assets, further cementing the relationship.

If the corresponding university's creditworthiness or student demand deteriorates significantly, a negative rating action could be taken on the transaction due to the irreplaceable nature of the sponsoring university as sole revenue counterparty. Although our assessment on corresponding universities has never posed a cap on a project's underlying rating in projects that we've rated recently, we believe the ongoing U.K. education reforms could potentially put pressure on the credit quality of second-tier universities.

How will the raising of tuition fees to £9,000 a year affect demand for student accommodation?

The new limit on tuition fees for U.K. and EU undergraduates came into effect in 2012 (see table 2). Overall, Standard & Poor's does not believe that the higher tuition fees will materially weaken underlying student demand, at least for the majority of universities that focus on school leavers. Although application levels for undergraduate entry in 2012, the first year of the new tuition fee regime, fell by 7.7%, more recent data for 2013 shows applications creeping back up by 3.5% as of the January 2013 application deadline. Perhaps more significantly, 2012 figures show that there was little decline (2.6%) in the largest and therefore single most important group of potential applicants: 18 year-olds. In 2013, applications from this demographic bounced back by almost 2%.

Part of the reason why student demand hasn't been affected more by the rise in tuition fees is the availability of loans, to cover the full fee and some living costs, from the government-owned Student Loans Co. on reasonably generous terms. That said, there is a risk that concerns about the higher cost of tuition fees, combined with a greater interest in part-time study, and advances in communications technology, could make living at home with parents (rather than in halls of residence) a more attractive option for some students, particularly where their interest in a subject may be more vocational than academic. Although there is little evidence to date of any major trend toward students living with their parents, we will continue to follow any changes in this area and any consequent pressure that this might place on universities' relationships with project companies.

Table 2

Maximum Annual Tuition Fees For 2012 U.K. Undergraduate Courses

	Location of institution			
Domicile of student	**England**	**Scotland**	**Wales**	**Northern Ireland**
England	Up to £9,000	Up to £9,000	Up to £9,000	Up to £9,000
Scotland	Up to £9,000	No fee	Up to £9,000	Up to £9,000
Wales	Up to £9,000	Up to £9,000	Up to £9,000	Up to £9,000
Northern Ireland	Up to £9,000	Up to £9,000	Up to £9,000	Up to £3,575
EU	Up to £9,000	No fee	Up to £9,000	Up to £3,575
Other international	Variable	Variable	Variable	Variable

Source: Universities & Colleges Admissions Service (UCAS).

Why are universities considering project financing to meet their student accommodation needs?

More positively for the future of project financing, the reforms to tuition fees have included a major reduction in the capital grant from the government. Consequently, universities looking to expand their student numbers and accommodation are attracted by a financing solution that generates a capital receipt for them, while also building infrastructure that may help attract students in a more competitive environment. Indeed, we believe there will be a continuing trend of universities entering into project finance structures with private sector partners to develop and maintain student accommodation projects with off-balance-sheet arrangements. Universities are often attracted to partnership arrangements because the financing structures can unlock capital receipts, enabling them to use these funds for other investment priorities. Other universities may discount the transfer price of existing accommodation or make a direct capital contribution to the project in order to secure newer and better quality accommodation for their students. Typically, the size of the capital contribution reflects the level of support that the university is prepared to provide throughout the term of the transaction. In such cases, we may consider the debt associated with a particular accommodation project to be an important contingent liability for the university, depending on the level of support provided.

How are the ongoing reforms to the student number control system likely to affect demand for student accommodation?

Importantly, the increase in tuition fees increases universities' exposure to the relaxation of controls on student numbers, another major reform introduced in 2012. As some universities choose to expand their student bodies, others are likely to contract, leading to higher revenue volatility than the sector is used to managing. We therefore believe that a university's management skills and expertise in setting fees, marketing the university, and managing ongoing changes to student demand in the context of an evolving public policy framework will become increasingly crucial to managing demand for the university, and hence demand for the related student accommodation.

Although it's still early to comment, we've seen that the consequences of the reform to student number controls, combined with a lower-than-expected number of top A-level grades, did lead to some volatility in 2012 enrolments. Sheffield University, for instance, which has a strong underlying demand profile, experienced an overall decline in its enrolments in 2012, as it was unable to recruit sufficient students with minimum grades of AAB as planned. The university also had to reject applications from students with lower grades, since it had already reached the relevant limit under the government's block grant. Consequently, Catalyst Higher Education (Sheffield) experienced a fall in occupancy in the 2012/2013 academic year to about 90%, which is significantly lower than ProjectCo's base-case forecast of 98% and our base-case forecast of 96%. However, we understand that ProjectCo and the University of Sheffield are reviewing admissions and accommodation-booking processes in order to reduce the likelihood of such a reduction reoccurring. Further changes to the admissions system mean that Sheffield is now likely to increase its enrolments in 2013. But other universities may find themselves more exposed in turn. (For more details on reforms to the student number control system, see "U.K. Higher Education Reforms Pose University Challenge," published June 25, 2013).

Are universities building accommodation for postgraduate and overseas students?

To a degree. Many universities are keen to expand their numbers of overseas and postgraduate students. Not only are such students outside the student number control system, but their tuition fees are unregulated and therefore tend to be higher. Moreover, as universities compete for overseas students, the quality of their accommodation, and its proximity to the campus, can prove important factors. Partly for these reasons, Edinburgh University, for instance, has taken an equity interest in the Holyrood transaction, focusing mainly on accommodation for postgraduates attending the university. (Edinburgh University can expand its tenant base to include undergraduates and students from other universities if it chooses to do so, including from Edinburgh Napier University and Heriot-Watt University.) The university has committed to market the new accommodation and allocate students on an equal basis to its own stock. This is the first postgraduate project we've rated, but we understand that there are other projects targeting overseas students. Such students tend to be more demanding in their accommodation requirements than domestic students.

However, there are several factors which could affect international student market growth: changes in the U.K. student visa system, which now prohibits students from staying in the U.K. after a course is completed; currency volatility; local policies; and the development of local universities (especially in China and India); and tuition fees. In the case of Edinburgh University, the institution is a long established, prestigious and well-ranked university, both domestically and worldwide, with intakes increasing each year.

Appendix: Individual U.K. Student Accommodation Project Profiles

Table 3

Rated U.K. Student Accommodation Projects

	Holyrood Student Accommodation Plc	ULivingAtHertfordshire	Catalyst Higher Education (Sheffield) PLC	UPP Bond 1 Issuer PLC	Keele Residential Funding PLC
Issue rating/Outlook*	BBB/Stable (SPUR)	A-/Stable	BBB/Negative (SPUR)	A-/Stable	A-/Positive (SPUR)
Location	U.K.	U.K.	U.K.	U.K.	U.K.
Status	Construction	Construction	Operational	Operational	Operational

Table 3

Rated U.K. Student Accommodation Projects (cont.)					
Revenue type	Volume risk	Volume risk	Volume risk	Volume risk	Volume risk
Constructor	Balfour Beatty Construction	Bouygues UK Ltd.	Bovis Lend Lease Ltd.	N/A	N/A
Completion	2016	2016	Four years in operation	Six years in operation	Eight years in operation
Leverage	82%	75%	89%	80%	94%
Standard & Poor's ADSCR (average/minimum)	1.22x/1.37x	1.75x/1.59x	1.37x/1.15x	1.49x/1.28x	1.62x/1.36x
Lifecycle risk	Lifecycle risk	Pass through	Pass through	Lifecycle risk	Pass through
Maintenance reserve account	Three years	Three years	100%/50%/25%	Three years	None at acceptable University rating. Otherwise five years
Portfolio	Single asset	Single asset	Single asset	Six assets	Single asset
Amortisation profile	59%/33%	34%/18%	33%/17%	--	--

*As of July 30, 2013. SPUR--Standard & Poor's underlying rating. ADSCR--Annual debt service coverage ratio. N/A--Not applicable.

UPP Bond 1 Issuer PLC

In March 2013, we assigned our 'A-' long-term issue rating to the £382.1 million of senior secured notes in two tranches ranking pari passu: a £307.1 million fixed-rate tranche due Feb. 28, 2040; and a £75 million index-linked tranche due Aug. 31, 2047. The notes are inaugural issues under the issuer's £5 billion multicurrency note program. The issuer has onlent the proceeds to refinance outstanding loans at six separate special-purpose vehicles (the AssetCos) currently operating accommodation for six U.K. universities under long-term concession agreements. These institutions are the University of Kent, University of Nottingham, Nottingham Trent University, Oxford Brookes University, Plymouth University, and University of York.

The issue ratings primarily reflect the benefit of cross-collateralization incorporated in the project's structure and a degree of revenue diversification. The structure allows the issuer to support any underperforming AssetCos through cash pooling at the parent holding level of excess cash from performing AssetCos. Rental income is generated from accommodation at six universities with strong student demand and credit profiles. This, in our view, partially mitigates the exposure to any single AssetCo's operating underperformance.

ULiving@Hertfordshire PLC

In May 2013, we assigned our 'A-' long-term issue rating to the £145 million senior secured index-linked bonds due 2054 issued to finance the development, maintenance, and operation of student accommodation at the College Lane Campus of the University of Hertfordshire (UoH) at Hatfield. The development includes the refurbishment of about 500 rooms, the demolition of about 1,000 rooms, and the rebuilding of about 2,500 rooms over a three-year construction period. The transaction benefits from a strong partnership with the UoH.

In addition to an equity interest in the project, the UoH agrees to restrictive covenants that limit future competing supply and commits to market and allocate students to the project accommodation on an even-handed basis as its own stock. Furthermore, under the concession agreement, the UoH will not set the rents at the de Havilland site--the closest competitor to ULiving--lower than the market rent. There is also a gains-sharing mechanism of a rent pool to provide an incentive to the UoH to approve rent increases, which should in our view help mitigate price risk to some extent.

Holyrood Student Accommodation Plc

In July 2013, we assigned our 'BBB' long-term underlying rating to the £31.5 million senior secured fixed-rate bonds and £31.5 million senior secured index-linked bonds, both due Aug. 28, 2048, and ranking pari passu. ProjectCo will use the proceeds for the development, maintenance, and operation of accommodation for postgraduate students, an outreach center, and a commercial restaurant (Holyrood Development) in partnership with the University of Edinburgh (UoE). The debt will be repaid from rental income on the student accommodation.

As well as a capital injection in the project, the UoE commits to market and allocate students on an equal basis to its own stock and agrees to a restrictive covenant limiting further accommodation developments. Furthermore, the UoE collects student rents and all other fees that are paid by students, effectively assuming credit and void risk on the behalf of the project.

Catalyst Higher Education (Sheffield) PLC

In 2006, Standard & Poor's assigned its debt rating to the £156.8 million secured index-linked bond, which is insured by Assured Guaranty (Europe) Ltd. (AGE; AA-/Stable/--), the monoline insurer. The current long-term SPUR is 'BBB'. The bond has funded the redevelopment of more than 4,000 student rooms close to the University of Sheffield, which involved the demolition of some of the existing premises and construction of new accommodation over a three-year period, completed in September 2009. The debt is to be repaid from rent received from the accommodation over 40 years.

Although this debt is off-balance-sheet for accounting purposes, the university guarantees part of the project income through minimum rental payments. The level of guarantee falls over time, reflecting the debt amortization profile of the transaction. Furthermore, an income-sharing mechanism provides the incentive for Sheffield to keep student accommodation occupancy levels high.

Keele Residential Funding PLC

The long-term rating on the £137.5 million index-linked guaranteed senior secured bonds due July 2047, issued by the U.K.-based special-purpose vehicle Keele Residential Funding PLC (ProjectCo), is 'AA-'. The rating reflects the unconditional and irrevocable payment guarantee of scheduled interest and principal provided by AGE. The SPUR on the bonds is 'A-'. The project benefits from a high level of interdependence with Keele University, which is responsible for setting student rents, providing soft FM, hard FM, and all lifecycle obligations. Furthermore, being the main sponsor, we believe the university's interests are aligned with ProjectCo to maintain high levels of occupancy. The university's consent to provide no more than 4,000 units of accommodation on campus over the term of the transaction limits further competition; the accommodation is in close proximity to the main campus and the university is charging below-average rents.

Related Criteria & Research

The articles listed below are available on RatingsDirect.

- Presale: Holyrood Student Accommodation PLC, July 15, 2013
- U.K. Higher Education Reforms Pose University Challenge, June 25, 2013
- Postsale: ULiving@Hertfordshire PLC, June 6, 2013
- Postsale: UPP Bond 1 Issuer PLC, March 6, 2013
- Project Finance Construction and Operations Counterparty Methodology, Dec. 20, 2011
- Student Accommodation Transactions Gain Momentum In The U.K. University Sector: An Update, Jan. 16, 2008

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