

**Credit Opinion: Great Places Housing Group**

Global Credit Research - 04 Jul 2016

United Kingdom

**Ratings**

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	A2
Senior Secured -Dom Curr	A2

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**Key Indicators**

Great Places Housing Group	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
Units under management (no.)	15,722	16,147	16,498	16,785	17,515
Housing assets (GBP million)	318	360	398	442	494
Operating margin, before interest (%)	18.6	24.5	28.7	30.0	34.0
Net capital expenditure as % turnover	81.4	72.2	39.9	45.9	48.5
Social housing letting interest coverage (x times)	0.9	1.4	1.7	1.1	1.3
Recurrent cash interest coverage (x times)	2.1	2.3	2.3	1.7	1.8
Debt to revenues (x times)	4.3	4.6	4.7	4.8	5.5
Debt to assets at cost (%)	36.0	37.0	39.0	39.6	41.7

**Opinion**

**SUMMARY RATING RATIONALE**

The A2 issuer rating assigned to Great Places Housing Group (GPHG) reflects: (1) the company's improving operating performance as a result of effective cost controls and improving collection rates; (2) the increasing proportion of turnover GPHG generates from low-risk social-housing letting; and (3) its solid liquidity position. However, the rating also takes into account: (1) GPHG's substantial development activity, which drives debt growth and reduces unencumbered assets; (2) its exposure to margin calls, which places additional demands on liquidity; and (3) GPHG's plans to increase its development-for-sale activity (albeit from a lower base), which is a more volatile source of revenue as reflected in historical operating results.

The A2 rating also benefits from the strong regulatory framework governing English housing associations, and our assessment that there is a strong likelihood that the UK government (Aa1 negative) would intervene in the event that GPHG faced acute liquidity stress.

GPHG is rated in the middle range of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. GPHG's relative position reflects its: stronger operating margin, social housing letting interest coverage in line with rated peers' median (although generally more volatile), above average but gradually contracting development programme and a higher debt-to-revenue ratio.

## **Credit Strengths**

Credit strengths for GPHG include:

- A track record of efficient cost control, which has led to a significantly improving financial performance
- A solid and increasing proportion of turnover generated from relatively lower-risk social housing lettings, enhancing cash flow stability
- A strong regulatory framework

## **Credit Challenges**

Credit challenges for GPHG include:

- Rising debt to support substantial development programme
- Government policy changes making operating environment less predictable and more challenging for housing associations
- Exposure to margin calls, which are met by cash collateral

## **Rating Outlook**

The negative outlook on GPHG's rating reflects the negative impact of the vote to leave the European Union on housing associations as well as the the negative outlook on the sovereign rating, reflecting the close institutional, operational and financial linkages between the central government and housing associations.

## **What Could Change the Rating - Up**

Moody's believes that upward ratings pressure on the HAs is unlikely to develop in view of the challenging operating environment and weakened sovereign credit conditions. Strengthening credit metrics of standalone credit profiles, however, could put stabilising pressure on GPHG's rating. A combination of the following could have positive rating implications: (1) an increase in the operating margin that outpaces expected growth in debt servicing costs and allows GPHG to structurally strengthen its interest coverage ratios; (2) a social-housing-letting interest coverage consistently at or above 1.5x, and recurrent cash interest coverage at or above 2.2x; (3) effective delivery of GPHG's current development pipeline coupled with a reduction of its development programme going forward, which would result in a gradual reduction of relative indebtedness and an increase in the value of GPHG's unencumbered assets, improving its financial flexibility.

## **What Could Change the Rating - Down**

Downward ratings pressure on the affected HAs would be prompted by further deterioration of the UK sovereigns' creditworthiness. Additionally, any sector or issuer-specific risks emerging in this context would exacerbate downward ratings pressures. The rating could come under negative pressure from a combination of the following: (1) a weakening of the operating margin coupled with sustained growth in debt that would lead to a fall in recurrent cash interest coverage below 1.5x, or a fall in social-housing-letting interest coverage below 1x; (2) a failure to deliver the development programme according to the existing schedule, which would put pressure on GPHG's level of unencumbered assets; and/or (3) weakening liquidity without any adjustments to GPHG's sizeable development programme. Any weakening of the regulatory framework or any dilution of the overall level of support from the UK government would also exert downward pressure on the rating.

## **Recent Developments**

On 23 June 2016, the UK voted to leave the European Union in a referendum and on 24 June 2016, a negative outlook was placed on the UK's Aa1 sovereign rating. We expect protracted trade negotiations, resulting in a high level of uncertainty in the medium term which will manifest in slower economic growth. On 28 June 2016, the outlook at GPHG's A2 rating was changed to negative from stable reflecting that the vote to leave the EU is negative for housing associations (HA), whose creditworthiness is linked to the sovereign, driven by three main factors: 1) reduction in the predictability of policy-making as the sovereign could squeeze HAs budgets through additional cuts in housing benefit, grants, or other policy channels, 2) volatility in the housing market, which would impact, in particular, those HAs with greater exposure to open-market sales, and 3) the loss of EU funding for capital spending and potentially higher cost of borrowing when raising debt on the capital market.

On 8 July 2015 the UK government announced a number of measures that we view as credit negative for the sector. Notably a 1% annual reduction in social housing rents over the next four years. The rent reduction coupled with additional benefit reforms create a more difficult operating environment for housing associations. Please see the section entitled "Government policy changes make operating environment more challenging for housing associations" for details.

## **DETAILED RATING CONSIDERATIONS**

GPHG's rating combines (1) its baseline credit assessment (BCA) of baa1 and (2) a strong likelihood of extraordinary support coming from the UK government in the event that GPHG faced acute liquidity stress.

### **Baseline Credit Assessment**

#### **TRACK RECORD OF EFFICIENT COST CONTROL, WHICH HAS LED TO A SIGNIFICANTLY IMPROVED FINANCIAL PERFORMANCE**

GPHG's operating margin has improved substantially over the past five years to levels which are above the median for Moody's-rated peers. The association's revenue has grown by more than £17 million between FY2015 and FY2011, while its operating costs have increased by just £1.2 million over the same period. As a result, GPHG's operating margin widened significantly to 34% of revenue in FY2015 from 19% in FY2011, compared to rated peers' FY2014 median of 29%. The improvement primarily reflects a successful cost-control policy adopted in 2010 which has resulted in a structural rationalisation of management and procurement costs, and improved rent collection rates. GPHG's current rent arrears declined to 3.4% in FY2015 from 5.3% in FY2011. GPHG's improved financial performance also demonstrates management's ability to consistently deliver on its ambitious projections. Despite the adverse impact of the Summer 2015 Budget announcement, GPHG's latest forecast shows its operating margin staying relatively stable around a solid 32% over the next five years as the reduction in rental income will be offset by the effect of GPHG's mitigating actions.

GPHG's interest coverage ratios have been volatile over the past few years, but have remained adequate for its position relative to rated peers. The recurrent cash interest coverage ratio (RCIC) was 1.8x in FY2015 and 1.7x in FY2014, below the 2.2x FY2014 median of rated peers; having fluctuated between 1.7x and 2.3x over the last five years. The decline in RCIC in FY2014 and FY2015 reflected an increase in interest costs following a bond issue in October 2012. The social-housing-letting interest coverage ratio (SHLIC, including depreciation), which measures GPHG's ability to cover interest costs from its core, low-risk activities, picked up to 1.3x in FY2015 from 1.1x the year previous, in line with the peer median for FY2015. GPHG expects the RCIC and SHLIC to remain close to these rates through FY2020.

#### **SOLID AND INCREASING PROPORTION OF TURNOVER GENERATED FROM LOWER-RISK SOCIAL HOUSING LETTINGS, ENHANCING CASH FLOW STABILITY**

GPHG's turnover remained relatively flat at £84 million in FY2015. Low-risk social housing lettings accounted for 87% of the total, close to rated peers' average, and up from 69% in FY2010. This supports cash flow stability and is credit positive. The growing contribution of SHL income reflects several factors, including: a reduction in turnover from outright sales owing to lack of suitable projects, which would meet the association's investment criteria (though this will pick up again in FY2016); falling revenue from higher-risk Supporting People Contract activities; and lower participation in development activities for other housing associations. GPHG maintains some exposure to commercial activities, but it is moderate compared to rated peers. Development for sale accounted for 5% of turnover in FY2015, similar to the last two years, but down from a peak of 10% in FY2010, and slightly below the rated peer average of 8% in FY2014. The vast majority of sales turnover came from first-tranche shared ownership units (£4 million). Sales margin has been volatile over the last five years, ranging from a peak of 47% in FY2011 to a low of -5% in FY2013. GPHG generated around £3.2 million of turnover from Supporting People Contracts in FY2015. This generated an operating loss of £1.3 million, reflecting the impact of austerity measures in the local authority sector.

GPHG's updated business plan for FY2016-20 envisages some expansion into commercial activities, but the level will likely remain in line with rated peers. The association plans to increase its outright sales turnover from FY2016 and GPHG's total sales revenue is projected to increase to around 11% of turnover on average over the next five years, compared with a 5% average in the five years previous. As part of its revised business plan, GPHG plans to alter the tenure of some of their development with first tranche shared ownership sales rising slightly to 5% of turnover over FY2016-20 from 4% in FY2015.

GPHG is a medium-sized provider of social housing managing around 17,500 homes as at March 2015.

Operations are concentrated in the north west of England, with core activities in and around the city of Manchester across 37 local authorities. The social rents in the region tend to be closer to market rents than in the south of England, reducing associations' market power. However, this fact has not had any material impact on the high demand for GPHG's properties, one of its key credit strengths. GPHG's group structure is simple, with GPHG as the group non-asset holding parent, which, by way of the centralised board and single management team, controls two registered subsidiaries: Great Places Housing Association and Plumlife Homes. The group also includes two unregistered subsidiaries, one focusing on outright sales and another on design and build contracts. GPHG is one of the leading developers in the north west of England. Its development strategy has been and remains significant, despite a gradual reduction, and has historically been supported by high grant levels and asset disposals. GPHG's business plan, however, envisages a significant reduction in grant funding going forward.

#### STRONG REGULATORY FRAMEWORK

English housing associations operate in a highly regulated environment, with a strong oversight exercised by the sector's regulator, the Homes and Communities Agency (HCA). The regulator is responsible for protecting the public investment in social housing and compliance with broad economic and consumer standards. Compliance with the standards is proactively monitored by the HCA through quarterly returns, long term business plan and annual reviews, and focuses on: governance, financial viability, value for money and rents. The HCA's levers of control are wide ranging and include awarding capital grant funding, consent to dispose of or use assets to secure debt, levy financial penalties, and impose independent inquiries or appoint new managers and officers in extreme circumstances. The HCA emphasizes that their role is a co-regulatory one with the primary onus being on boards and executive teams to ensure compliance with the standards. We expect that the rapidly changing environment will put increased pressure on the regulator.

#### RISING DEBT TO SUPPORT SUBSTANTIAL DEVELOPMENT PROGRAMME

GPHG's debt was £467 million as at FYE2015, around 5.5x revenues and 42% of assets at cost, up from 3.8x and 34% in FY2010. The increase is faster than the average for rated peers, whose collective debt-to-revenue ratio increased to 4.2x at FYE2015 from 4.0x in FYE2010. The rise reflects GPHG's sizeable social housing unit development programme, which averaged 58% of revenues during FY2011-2015, peaking at 81% in FY2011. By comparison, social housing development accounted for 28% of revenues on average across the rated peer group in FY2014. Following the Budget announcement, one element of GPHG's mitigation plan is a reduction in capex over FY2016-20 to levels around 30% of revenues. However, capex will remain large enough to fuel further, although slower, increases in indebtedness to around 5.8x of revenues by FY2019. Debt-to-assets is projected to hover around 42-43% through FY2016-20.

Refinancing risk is limited, with 94% of outstanding debt coming due after five years as at FYE2015. However, GPHG plans to continue to draw on its immediately available £60 million revolving facility to support new developments, which will create a refinancing exposure in FY2019. This may be addressed by utilising GPHG's additional contracted facilities.

Interest rate risk within GPHG's debt portfolio reduced significantly after the issuance of its 30-year, £200 million fixed-rate bond in October 2012. The association issued £150 million upfront, £31.8 million in December 2013 and the final £18.2 million in September 2014. GPHG held only 7% of its debt at floating rates as of March 2015, down sharply from over 30% pre-bond, increasing cash flow predictability. The latest position is in line with GPHG's treasury policy, which was updated in July 2015 and now requires a minimal proportion of fixed rate debt to be within 75-100% compared with 65-75% previously. The loan portfolio includes cancellable options of £27 million, which could add floating-rate risk, but we do not expect these to be exercised in the current low-interest-rate environment.

#### GOVERNMENT POLICY CHANGES MAKING OPERATING ENVIRONMENT LESS PREDICTABLE AND MORE CHALLENGING FOR HOUSING ASSOCIATIONS

The operating environment for social housing providers is fundamentally shaped by government policy and recent budget announcements have made this environment more challenging. On 8 July 2015, the UK government announced a change in the social housing rent formula to 1% annual reduction starting from April 2016 for 4 years (previously growth annually by CPI+1%) as well as further reductions in the accessibility of certain welfare benefits. The effect of these measures is further magnified by the ongoing implementation of Universal Credit and the likely extension of Right to Buy for HA tenants. Overall, these policy shifts are gradually eroding the ties to the government by creating a more unpredictable operating environment and undermining the extent and stability of housing benefit's contribution to revenues.

Our preliminary assessment indicates that the change in the rent formula will result in an average annual loss in total turnover of 7% for our rated portfolio over the four years starting FY2017. It is also likely to cause a decline in a currently high proportion of housing associations' turnover coming from social housing rents (median of 83% in FY2014).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 27% of GPHG's total income, compared to the latest average of 29% for Moody's-rated peers. We view this risk as manageable for most housing associations given management's high awareness of the issue and a range of mitigating measures being typically put in place, including proactive management of rent arrears, support for tenants or promotion of direct debit payments. The possible extension of the Right to Buy to housing association tenants may lead to positive cash inflows in the short-term, but creates a risk of a longer term erosion of social housing stock. We do not expect GPHG to be significantly impacted by the extension of Right to Buy. The association's preliminary assessment indicates that around 100 per year for three years starting FY2018 and 30 per year from FY2021 could be sold (compared to current stock of over 17,500 units) as a result of the extension.

#### EXPOSURE TO MARGIN CALLS, WHICH ARE MET BY CASH COLLATERAL

GPHG hedges a sizeable share of its interest-rate risk using standalone swaps. These contracts have a notional value of £127 million, and had a negative mark-to-market value of over £39 million at the end of August 2015. The resulting margin call of about £17 million was fully met by cash collateral. Cash posting is more flexible than using property as security. However, it adds complexity to cash management, requires strict monitoring, and limits liquidity, a critical consideration for housing associations such as GPHG with large development programmes.

GPHG's liquidity position is solid compared to its peers and adequate given its sizeable development programme, providing cash required for the next three years. As of 30 June 2015, GPHG's immediately available liquidity, represented by cash and undrawn facilities that are readily available, was £108 million or 128% of turnover, above the latest rated peer average of 98%. Total liquidity, i.e. immediately available liquidity and undrawn facilities requiring property security before drawing, was significantly higher at 269% of turnover. However, GPHG has fewer unencumbered assets of the kind needed to secure undrawn facilities than its rated peers, which currently constrains its rating. GPHG estimated that its unencumbered assets could support £112.5 million of new secured debt at the end of June 2015, equivalent to 133% of turnover, below the latest rated peer average of 206%. Favourably, GPHG strengthened its liquidity policies during a regular review of its treasury strategy in July 2015. It increased a requirement to for a minimal level of cash balances at all times to £20 million from £10 million.

In addition to the minimal £20 million cash balance, GPHG's treasury policy requires the immediately available liquidity to cover the net cash outflow for the next calendar month and total liquidity required to cover 12 month cash requirements, as well as all contractually committed liabilities falling due after one year and before three years. As of 30 June 2015, all requirements were met. Management sets internal buffers for its financial performance and covenants (interest cover and gearing). All debt covenants are fully met.

#### Extraordinary Support Considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers of redress available to the regulator in cases of financial distress, with the possibility of a facilitated merger or a transfer of engagements. Recent history has shown that the UK government is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support also factors housing associations' increasing exposure to non-core social housing activities, that add complexity to their operations and make an extraordinary intervention more challenging.

In addition, our assessment that there is a very high default dependence between GPHG and the UK government reflects their strong financial and operational linkages.

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The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

#### Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

#### Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a Government Related Issuer (GRI) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0 - 30%), moderate (31 - 50%), strong (51 - 70%), high (71 - 90%) and very high (91 - 100%).

#### Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to GRIs, default dependence reflects the tendency of the GRI and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the government to provide extraordinary support and prevent a default by a GRI is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' credit profiles, the lower the benefits achieved from joint support. In most cases GRIs demonstrate moderate to very high degrees of default dependence with their supporting governments, which reflects the existence of institutional linkages and shared exposure to economic conditions that draw credit profiles together.

Default dependence is described as either low (30%), moderate (50%), high (70%) and very high (90%).

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