

Credit Opinion: Great Places Housing Group

Global Credit Research - 20 Nov 2013

United Kingdom

Ratings

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

Contacts

Analyst	Phone
Elizabeth Bergman/London	44.20.7772.5454
Roshana Arasaratnam/London	
David Rubinoff/London	

Key Indicators

Great Places Housing Group

	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13
Units under management (no.)	14,781	14,969	15,722	16,147	16,498
Housing assets (GBP million)	270	310	318	360	398
Operating margin, before interest (%)	20.8	19.0	18.6	24.5	28.8
Net capital expenditure as % turnover	75.2	18.3	81.4	72.2	40.0
Social housing letting interest coverage (x times)	1.0	1.3	0.9	1.4	1.6
Recurrent cash interest coverage (x times)	1.5	2.2	2.1	2.3	2.3
Debt to revenues (x times)	3.9	3.8	4.3	4.6	4.8
Debt to assets at cost (%)	35.2	33.9	36.0	37.0	39.0

Opinion

SUMMARY RATING RATIONALE

The A2 issuer rating assigned to Great Places Housing Group (GPHG) reflects the company's improving operating performance as a result of effective cost controls, and the strong cash flows it generates from a robust foundation of low-risk social-housing letting. However, the rating is constrained by GPHG's (1) substantial development activity that drives debt growth; (2) exposure to margin calls that limit liquidity; and (3) revenue mix, which includes Supporting People contract income and sales, both volatile revenue sources as reflected in historical operating results

In addition, ratings in the sector benefit from (1) the strong regulatory framework governing English housing associations; (2) the revenue stability provided by government subsidies (housing benefit), although this may come under pressure from the introduction of universal credit; and (3) our assessment that there is a strong likelihood that the UK government (Aa1, stable) would intervene in the event that GPHG faces acute liquidity stress.

GPHG is rated in the middle range of Moody's-rated English housing associations, whose ratings span from Aa3 to A3. GPHG's relative position reflects its stronger cash flows and interest coverage, but larger development programme, rising debt levels, and more complex debt portfolio, including stand-alone swaps and cancellable fixes.

Credit Strengths

Credit strengths for GPHG include:

- Track record of efficient cost control, leading to an improving operating performance
- Strong cash flow, supported by growing social-housing letting and no planned reliance on sales to cover interest costs
- Strong ongoing support from the UK government, including an effective regulatory framework and the receipt of a significant share of revenue (47% for GPHG) from housing benefit
- Our assessment of a strong likelihood of extraordinary support from the UK government

Credit Challenges

Credit challenges for GPHG include:

- Rising debt to support substantial development programme
- Exposure to margin calls, which are met by cash collateral
- Comparatively average exposure to the implementation of welfare reform, which introduces uncertainty to revenues and cash flow

Rating Outlook

The outlook on GPHG's rating is stable.

What Could Change the Rating - Up

A combination of the following could have positive rating implications: (1) a stronger operating margin structurally above 30%; (2) a more robust and stable social-housing-letting interest coverage above 1.6x and recurrent-cash interest coverage above 2.3x; (3) a reduction in debt below 4.0x revenues; and/or (4) an upgrade of the UK sovereign rating.

What Could Change the Rating - Down

Negative pressure could be exerted on the rating by a combination of the following (1) a weaker operating margin below 20%; (2) lower recurrent-cash interest coverage below 1.5x or social-housing-letting interest coverage below 1x; and/or (3) higher-than-projected debt above 5.5x. In addition, a weaker regulatory framework, a dilution of the overall level of support from the UK government or a downgrade of the UK sovereign rating would also exert downward pressure on the rating.

DETAILED RATING CONSIDERATIONS

The rating assigned to GPHG reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for Government-Related Issuers. In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for GPHG and then considers the likelihood of support coming from the UK government in the event that GPHG faces acute liquidity stress.

Baseline Credit Assessment

GPHG's BCA of baa2 reflects the following factors:

Institutional Framework

English housing associations operate in a highly regulated environment, with strong oversight exercised by the sector's regulator, the Homes and Communities Agency (HCA). The HCA's levers of control are extensive and currently range from monitoring the quality of accommodation, to vetting governance and financial viability and arranging short-term property inspections.

Housing associations have limited revenue flexibility, but a majority of their revenue is stable and predictable. An annual increase in social housing rent, which represents the bulk of revenues for most housing associations (79%

for GPHG), is currently capped at a rate of the retail price index (RPI) + 0.5%. Recent reforms have granted greater rent flexibility by allowing social-housing rents to rise up to 80% of market rent ("affordable rent") for new tenants and re-lets. This reform is credit positive, but is limited in impact given that new tenants and re-lets account for a minor proportion of most housing associations' total income. Housing associations in economically stronger regions, where the difference between social housing and market rent is greater, may benefit more from the reform. The Comprehensive Spending Review 2013 announced that social rents will rise by the consumer price index (CPI) + 1% from 2015/16 for 10 years, which is expected to be credit neutral, as although it provides certainty and stability to housing associations' planning and operations, we expect it to limit rent increases and constrain revenue growth.

A high share of social-housing rental income is composed of housing benefit (54% average for Moody's-rated peers; 59% for GPHG), which has provided a stable and secure revenue stream to housing associations over the year. That being said, the progressive roll-out of universal credit from October 2013 (and full transition by 2017) will see the benefits of working-age tenants paid directly to tenants (rather than to housing associations directly prior to reform), which is a source of credit risk for the sector. We view this risk as manageable for most housing associations given the sector's policy responses. For example, GPHG has mitigated the risk by (1) improving its rent-collection rates, with current rent arrears now at 4.5% (4.7% at FYE2012); and (2) recent initiatives to increase awareness of the reform to tenants and to employees, to improve tenants data, to strengthen collection procedures and staffing and to support direct debit payments (GPHG estimates that around 20% of rental income is paid by direct debit, compared to an average of 24% of Moody's-rated peers). Housing benefit paid to working-age tenants represents an estimated 26% of GPHG's total income, compared to the current average of 29% for Moody's-rated peers.

Issuer Profile

GPHG is a medium-sized, social-housing provider, managing around 16,500 homes as at March 2013. Operations are concentrated in the north west of England, with core activities in and around the city of Manchester across 37 local authorities, where demand for social housing is high and social housing rents may go up to half market rates.

Financial Performance

GPHG's financial performance has improved over the past three years to levels which are in line with the average for Moody's-rated peers. The strengthening mainly reflects a successful cost-control policy that GPHG has followed since 2010.

GPHG's revenue grew to £80 million in FY2013 (2012: £72 million), supported by stable growth in social-housing letting (79% of revenues) and increase in sales (6%, 2012: 3%). The vast majority of sales were first-tranche shared ownership. Increased sales activity, however, failed to make a positive contribution to the company's operating margin. In fact, GPHG reported a small loss on sales of £0.2 million, which was attributable to an accounting correction of an overstated sales surplus in FY2012; excluding this one-off, sales activity would breakeven in FY2013. Higher-risk Supporting People contract income activities (specifically Supporting People contracts) generated an operating loss of £1.2 million (the company had forecast a loss of £0.6 million for the year), reflecting the impact of austerity measures in the local authority sector. Nonetheless, GPHG's operating margin widened to 29% of revenue in FY2013 (2012: 24%; average 2009-2013: 22%), reflecting a reduction in expenditure on social-housing lettings of 1.3% and an increase of almost 9% in the social-housing turnover. The margin mirrors the average for Moody's-rated peers and is slightly better than anticipated in budget for 2013.

However, its bottom-line margin (before tax) was stable at 10% of revenues in FY2013 (2012: 10% average 2009-2013: 7%) as an improved operating performance was offset by an increase in interest expenses (up by 50%) following GPHG's bond issuance of £200 million (£150 million drawn and £50 million retained) in September 2012.

GPHG's recurrent cash-interest coverage ratio was strong at 2.3x in 2013 (2012: 2.3x; average 2009-2013: 2.1x; peak/trough 2009-2013: 2.3x/1.5x), which is slightly above the average of Moody's-rated peers. The social-housing-letting interest coverage ratio, including depreciation, improved to 1.6x in 2013 (2012: 1.4x; average 2009-2013: 1.2x; peak/trough 2008-2012: 1.6x/0.9x).

GPHG forecasts that a strong rise in social-housing letting will continue to drive its revenue growth. It does not expect to increase its exposure to higher-risk activities such as sales, market rent or Supporting People contract income. As a result, sales revenue is forecast to remain stable at existing levels of around 6% of turnover. Despite the results from FY2013, sales are expected to perform well in 2014-18, delivering on average a margin of 19%, which is above an average of 12% achieved over the last five years. GPHG is more conservative in case of Supporting People contracts, where income is projected to decrease sharply, resulting in average loss of GBP2.7

million over 2014-18. Overall, GPHG's operating margin is projected to widen further to around 32% revenues, reflecting a continuing focus on cost efficiencies and a steady delivery of new social rental units. However, the social-housing-letting interest coverage is forecast to weaken to around 1.2x in 2014-15 after which it recovers to 1.5x in 2016-18. Recurrent cash-interest coverage is forecast to drop to 1.7x in 2014 and gradually improve to 2.0x by 2018. The projected reduction in interest coverage is mostly attributable to a rise in interest costs from a planned issue of retained bond and draw-downs on existing revolving facility to support GPHG's extensive capex.

Debt profile and liquidity

At FY2013, debt was £379 million, equivalent to around 4.8x revenues and 39% of assets at cost, a level which is in line with an average for Moody's-rated peers (4.6x and 47% 2013 average, respectively). Debt has seen only a modest growth over the last five years (3.9x in FY2009) despite the company's substantial investment programme, which averaged around 57% of revenues in 2009-2013 and peaked at 81% in 2011. Current debt levels are a function of historically high grant levels and reinvested proceeds from asset disposals.

Going forward, GPHG projects its capex to remain robust, averaging at 45% of revenues in 2014-18 and peaking at 71% in 2014. We expect that it will fuel debt growth to around 5.5x revenues and 43% of assets by 2018. The expected contribution to capex from fixed-asset disposals has fallen since the previous business plan, averaging 6% of revenues in 2014-18 (projected 13% for 2013-17).

Refinancing risk is limited, with 99% of outstanding debt coming due after five years as at FY2013. However, GPHG will be drawing on its currently available £60 million revolving facility to support new developments, which will create a refinancing exposure in FY2017. This may be addressed by utilising GPHG's additional available facilities.

Interest-rate risk within GPHG's debt portfolio reduced significantly after the bond issuance. As of March 2013, only 7% of debt was held at floating rates, as opposed to over 30% pre-bond. According to GPHG's treasury management policy, floating-rate debt should account for 15-35% of total debt. The group board has approved the level of hedging to be temporarily above the target level, which results from the bond issue and is expected to be reversed by FYE2014 as GPHG draws variable-rate debt from its revolving facilities. The loan portfolio includes cancellable options of £19 million, which could add floating-rate risk, but we do not expect these to be exercised in the currently low-interest-rate environment. A sizeable share of GPHG hedging is carried out by standalone swaps (notional of £127 million). As of 21 June 2013 these contracts had a negative marked-to-market value of £25.5 million. The resulting margin call of £5.1 million was fully met by cash collateral.

Cash posting is more flexible than using property security, although it adds complexity to cash management, requires strict monitoring and limits liquidity (the latter is crucial for housing associations with large development programmes). As of 30 June 2013 GPHG's immediately available liquidity, represented by cash and undrawn facilities that are readily available, was £64 million or 80% of turnover, which was below an average of Moody's rated peers. However, total liquidity, adding undrawn facilities still requiring property security, was significantly higher at £260 million and sufficient to cover forecasted cash requirements (including uncommitted development) until mid-FY2018. Further potential liquidity is represented by GPHG's pool of unencumbered assets, which was estimated to support £214 million (269% of turnover) of new secured debt at EUV/MVT as of 31 October 2013, as compared to £196 million of available facilities that still required security collateral (including the retained bond of £50 million) at the end of June 2013.

Governance and management

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 (14,500 units) and Plumlife Homes (2,000 units). The group also includes two unregistered subsidiaries, one focusing on outright sales and another on development activity. GPH is one of the leading developers in the north west of England. Its development strategy has been and remains significant and has historically been supported by high grant levels and asset disposals, with its reliance on the latter expected to be reduced going forward. GPHG's response to affordable rent / lower grant rates includes some cross-subsidy from development-for-sales (averaging 6% in 2014-18), but not to such an extent as other rated peers (averaging 11% in 2014-18). Instead, GPHG is forecasting an increase in debt to finance development social-rent units.

The business plan for 2014-18 is a prudent scenario and is based on LIBOR at 1.5% in 2014 (2.25% in 2015, 3.0% in 2016, 5.0% in 2017 and 2018), rent RPI at 2.6% in 2014 (3.0% in 2014 and 2.5% from 2015), nil repair and maintenance inflation until 2016, rising bad debts from 1.5% in 2014 to 4% by 2018, sharply falling supported-people income, nil property price inflation in 2014-15 and nil affordable rent conversions beyond 2015. Rents are

assumed to increase by RPI+0.5% until 2015 and by RPI+0.25% from 2016 onwards.

GPHG has strengthened its liquidity policies in FY2013 by distinguishing between different types of liquidity and linking liquidity requirements to forecasted activity, which is a common practise in the sector and is better suited for a large developer. As a result, immediately available liquidity is required to cover the net cash outflow for the next calendar month and total liquidity required to cover 12 months cash requirements as well as all contractually committed liabilities falling due after one year and before three years. As of 30 June 2013, all requirements were met. Management sets internal buffers for its financial performance and covenants (interest cover and gearing). All debt covenants are fully met and allow for strong headroom within the business plan.

GPHG's governance rating from the HCA was lowered in June 2013 to G2 from G1, reflecting regulator's concerns over potential weaknesses in the group's risk management and internal control assurance frameworks. Specifically, the HCA identified weak governance related to the way that executive contracts and severance payments had been agreed, scrutinised and reviewed. These concerns surfaced after the departure of GPHG's chief executive in April 2013. GPHG has already engaged with independent advisors and taken corrective action to strengthen its governance arrangements; this included the chair and two other board members stepping down and an independent review of the company's governance.

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.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in October 2012 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

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%).



© 2013 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as

well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable, including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for retail clients to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.