

**Credit Opinion: Moat Homes**

Global Credit Research - 30 Jun 2016

United Kingdom

**Ratings**

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	A1
<b>Moat Homes Finance Plc</b>	
Outlook	Negative
Senior Secured -Dom Curr	A1

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**Key Indicators**

**Moat Homes**

	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
Units under management (no.)	20,834	20,700	20,951	20,922	21,115
Housing assets (GBP million)	501	519	566	636	690
Operating margin, before interest (%)	29.3	32.5	35.3	36.7	34.7
Net capital expenditure as % turnover	52.3	52.5	39.1	51.8	63.9
Social housing letting interest coverage (x times)	1.5	1.6	1.8	1.6	1.5
Recurrent cash interest coverage (x times)	2.4	2.5	2.5	2.4	2.2
Debt to revenues (x times)	3.8	3.8	3.7	3.9	3.8
Debt to assets at cost (%)	30.0	29.7	30.0	30.8	32.1

**Opinion**

**SUMMARY RATING RATIONALE**

The A1 issuer rating assigned to Moat Homes (MOA) reflects (1) strong financial performance including operating margins and interest coverage which are among the highest of Moody's-rated peers; and (2) strong cash flows from a robust foundation of low-risk social-housing letting and moderate sales. The rating also takes into account rising debt levels to support capex and strong long term liquidity.

In addition, the rating 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 MOA faced acute liquidity stress.

MOA is rated at the upper end of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. MOA's relative position reflects its strong margins, cash flows and balance sheet, but its exposure to sales and development pipeline contribute to higher debt levels and weakening coverage going forward.

**Credit Strengths**

- Strong interest coverage metrics and margins, in-line with peers
- Large housing association with high level of social housing activities
- Strong regulatory framework

### **Credit Challenges**

- A development programme which includes more risky open market sales and rent activity
- Debt projected to increase from currently modest levels for the sector, albeit more slowly than previously projected
- Government policy changes make operating environment more challenging for housing associations

### **Rating Outlook**

The negative outlook on MOA'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 MOA's rating. One or a combination of the following could have positive rating implications: (1) social-housing-letting interest coverage that is sustained above 1.7x; (2) debt below 3.5x revenue; (3) maintenance of healthy operating margins at levels above sector averages; and/or (4) a reduction in capex requirements.

### **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. Negative pressure could be exerted on the rating by one or a combination of following: (1) expansion of outright sales programme and/or increased exposure to housing market volatility; (2) significant deterioration of social housing letting coverage; (3) a marked increase in debt above those in the current business plan (peaking at 5x revenue in 2020). 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.

### **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 MOA's A1 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.

### **DETAILED RATING CONSIDERATIONS**

MOA's A1 rating combines (1) a baseline credit assessment (BCA) for the entity of a3 and (2) a strong likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

### **Baseline Credit Assessment**

MOA's BCA of a3 reflects the following factors:

**AMPLE COVERAGE AND VERY STRONG MARGINS**

MOA's operating margin was 35% of revenues in 2015. Despite margins being among the highest for Moody's-rated peers, the 2015 result reflects a slight decline from 2014 (37%) given the loss of revenues associated with its role as agent for the Help to Buy Programme in the south east. MOA's total margin (before tax) remained stable at 25% of revenues in 2015 (average 2011-15: 23%). Strong sales prices meant that first tranche of shared-ownership properties registered strong margins at 30% in 2015 (up from 28% in 2014) continuing to support total margins.

Interest coverage ratios remained healthy, but 2015 results show them slightly weaker than in 2014, factoring GBP1.6 million in 2015 breakage costs included in interest expense. The social-housing-letting interest-coverage ratio is strong 1.5x in 2015 and excluding breakage costs stable from last year at 2014 (1.6x). The recurrent cash-interest coverage ratio at 2.2x in 2015 (2.3x netting off breakage costs), compares to 2.4x in 2014 and remains above the median of the 2.15x of Moody's-rated peers.

The current business plan, approved by the Board in October 2015, projects a drop in the operating margin to just below 30% this year, with the ratio remaining at that level over the next five years. Operating surplus projections for this year, FY2015/16, are negatively affected by the booking of a one-off £4.5 million charge related to a grant-subsidised equity loan scheme called My Choice Homebuy. Moat's legal counsel advised the company to make the payments in order to rectify past non-compliance with consumer credit legislation relating to the form of notices sent to customers of the scheme. Interest coverage is projected to decline given additional borrowing needs, with social-housing letting interest coverage to decline to 1.3x as of FY 2016/17. However, MOA has a track record of using conservative assumptions in its business plan and then out-performing projections. The revised business plan maintains generous levels of headroom in terms of covenant compliance.

#### MEDIUM-SIZED HOUSING ASSOCIATION WITH A HIGH LEVEL OF SOCIAL HOUSING ACTIVITIES

MOA is a medium-sized provider of social housing in England, with around 21,000 units under management. Located in the south east of England, demand for social housing is high and social-housing rents may reach up to half market rates (social rents are approximately 50% of market). Operations have been consolidated down to 46 key local authority areas, from 60 in 2009 as MOA worked to achieve efficiencies. Over that period management costs per unit have fallen by nearly 50%. MOA is looking to further streamline, with a view to be focused on 30 core local authority areas by 2020.

Moat Homes Limited (MHL) is a registered provider and the asset holding parent of the group. There are four non-charitable subsidiaries, two of which are dormant. Moat Housing Group Limited (MHG) is a registered provider which is predominately a developer of homes for outright sale. As mentioned in the recent developments section of this report, management is looking to deregister MHG. For legacy reasons, the subsidiary employs all MOA's staff and had an investment in Chrysalis (Stanhope) Holdings, which is a PFI associated with regeneration of the Stanhope Estate in Ashford. The Chrysalis investment was sold in February of this year, although Moat retains a management role. As a part of the commercialization of MHG, all employees and social housing assets will move to MHL. Moat Homes Plc. is a financing vehicle. The board was recently downsized by two members to 12.

MOA's revenue grew to GBP107.1 million in 2015 (2014: GBP96.8 million), mainly driven by social housing letting, which comprised 77% of revenues. This is a small decrease from historical levels of 80% over the last 4 years and slightly below Moody's rated peers median of 83%, which is due to increase sales revenue from a combination of first-tranche shared-ownership sales and outright sales. The current business plan projects social housing letting to rise back to 82% of turnover this fiscal year, and over the next four years to average 75% of revenue.

MOA considers itself a shared ownership specialist, with nearly 25% stock in shared ownership. Over the next five years, shared ownership units will represent 40-50% of MOA's new development. Given that the rental portion of shared ownership properties are not linked to the rent formula, and hence not subject to the rent cuts announced in July 2015, we expect MOA to be more resilient to this policy change than some of their peers.

#### 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.

#### PLANNED CAPITAL EXPENDITURE TO RISE, BUT REMAIN CLOSE TO HISTORICAL AVERAGE IN THE MEDIUM-TERM, SUPPORTED BY STRONG LIQUIDITY

As discussed in the recent developments section, MOA has cut building targets of 700 units per year to 400, due to pressures on the social housing sector and projected lost income from the announced rent cut. As a result, capital expenditure and corresponding debt levels are set to rise in the medium term, albeit more slowly than previously projected. The current business plan shows net capex as a percent of turnover falling back to 44% as of FY 2016/17, from 64% in FY2014/15, and to return to the historic average of about 50% in the following three years.

Preliminary capex numbers for FY2015/16 show that MOA spent approximately GBP30 million in net terms less than projected. The underspend is due to combination of factors, with some purchases being reallocated to the next fiscal year, building costs per unit coming in lower than planned, and revenues from asset sales stronger than forecast. While the mismatch between ambition and actual spend can signal an area of concern, we note the improvement in the discrepancy in this fiscal year as compared to FY2014/15 when MOA's underspend in net terms was about GBP90 million.

MOA's funding needs are offset by its strong liquidity; as of end-February 2016, immediately available liquidity totals GBP119 million, which is equivalent to over 100% of revenues, above the average of Moody's rated peers. Further potential liquidity is represented by unencumbered property for security, which is estimated could be used to generate an additional GBP400 million of liquidity (approximately 4x turnover). Moat's cash policy requires sufficient liquid funds to cover six months of net cash requirement, moreover short term facilities should at all times cover committed development.

#### DEBT LEVELS PROJECTED TO INCREASE AT A MORE MODEST PACE

As of end-February 2016, MOA's long-term debt was GBP417.7 million, a relatively small 3% increase since the beginning of the fiscal year, equivalent to 3.9x projected 2015/16 revenues and 33% of assets at cost, essentially the same ratios as the past five years. The revised business plan anticipates that debt will grow to around 5x revenue by 2020, a more modest build-up of debt than previously anticipated. However, we expect that debt may not increase at the rate included in projections as this represents yet another area of conservatism for MOA.

Refinancing risk is low, with around 90% of MOA's outstanding debt was due after five years. The amortisation profile is smooth, with the earliest peak repayment of around GBP25 million in 2019 and a concentration in 2043 as a result of the 2011 bullet bond. The company's interest-rate risk was slightly above average, with about 24% of debt held at floating rates.

MOA has a clear and comprehensive treasury policy. Included are the commitment to have facilities in place for the committed capital programme and a debt mix which allows for between 10-40% variable rate borrowing. Additionally MOA has a traffic light system in place to monitor the treasury performance against performance targets.

#### GOVERNMENT POLICY CHANGES MAKE OPERATING ENVIRONMENT MORE CHALLENGING FOR HOUSING ASSOCIATIONS

The operating environment for social housing providers is fundamentally shaped by government policy and recent budget announcements have made these circumstances more challenging. On July 8th, 2015 the UK government announced (1) a change in the social housing rent formula to 1% annual reduction starting from April 2016 for four years (previously growth annually by CPI+1%) and (2) 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, which we view as credit negative, 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 (73% in FY2015).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 25% of Moat's total income, compared to 29% average for Moody's-rated peers. Moat put in place a range of mitigating measures to respond to Welfare Reform, 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 in short-term lead to positive cash inflows, but creates a risk of a longer term erosion of social housing stock. We will continue to monitor the impact of the proposed Right to Buy extension on Moat's asset base and revenues.

### **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 in housing associations' increasing exposure to non-core social housing activities, which adds complexity to their operations and makes an extraordinary intervention more challenging.

In addition, our assessment that there is a very high default dependence between MOA 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 Credit 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 credit 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 ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 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%)

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