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CREDIT OPINION
13 December 2017

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RATINGS

Clarion Housing Group Limited

Domicile	United Kingdom
Long Term Rating	A3
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Jeanne Harrison 44-20-7772-1751
VP-Senior Analyst
jeanne.harrison@moodys.com

Matt Fawcett 44-20-7772-5326
Associate Analyst
matt.fawcett@moodys.com

Sebastien Hay 34-91-768-8222
Senior Vice President/ Manager
sebastien.hay@moodys.com

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Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
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Clarion Housing Group Limited

Update to credit analysis

Summary Rating Rationale

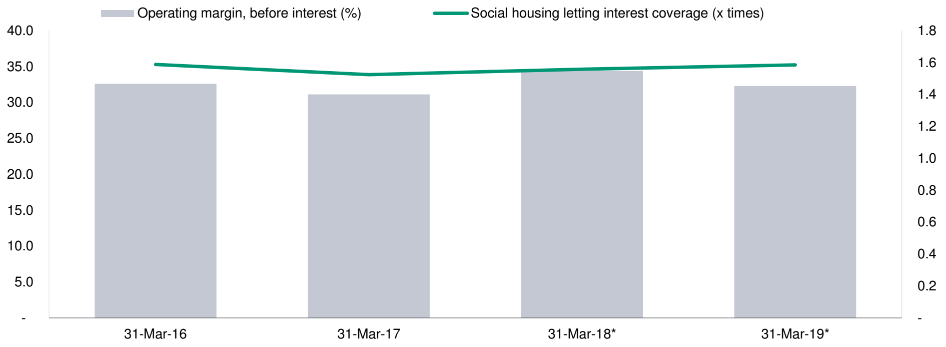
Clarion Housing Group Limited's (Clarion) credit quality reflects its (1) size as one of the UK's largest housing associations, (2) stable profitability and interest cover, and (3) solid liquidity supported by strong unencumbered assets and robust treasury policy. Clarion also benefits from the strong regulatory framework governing English housing associations (HAs), and our assessment that there is a strong likelihood that the UK government (Aa2 stable) would intervene in the event that Clarion faced acute liquidity stress.

Clarion's credit quality is constrained by its (1) rising market sales and significant exposure to development risk, (2) increasing debt in the medium term and; (3) implementation risks surrounding merger last year. Clarion is rated in the middle of the range of Moody's-rated English housing associations, whose ratings span from A1 to Baa2.

Exhibit 1

Social housing letting interest coverage and operating margin forecast to remain stable

Operating margin (%) (LHS), Social housing letting interest coverage (x) (RHS)



All figures are FRS 102 compliant, FY2016 and FY2017 are from audited financial statements and FY2018-FY2019 are forecasts
Source: Moody's Investors Service, Clarion Housing Group

Credit Strengths

- One of the largest housing associations in the UK
- Stable operating margin and interest cover
- Solid liquidity position supported by strong unencumbered assets and robust treasury policy
- Strong regulatory framework

Credit Challenges

- Increasing exposure to market sales
- Merger consolidation challenges, but positive progress on group structure
- Increasing debt in the medium term, but debt metrics stable
- Operating environment remains challenging but policy is more stable

Rating Outlook

The stable outlook on Clarion reflects the currently stable operating environment, which is unlikely to undergo further material change in the medium term, and the stable outlook on the sovereign rating.

Recent Developments

On September 26th 2017, Clarion's rating was downgraded to A3 from A2 to reflect the close institutional, operational and financial linkages between the central government and UK housing associations (HAs), and the reduced financial resilience of the sovereign as captured by Moody's recent decision to downgrade the UK's sovereign rating to Aa2 from Aa1. The outlook has been changed to stable from negative to reflect the stable outlook on the sovereign rating, and the HA sector adapting well to a challenging policy environment, which is not expected to undergo further material change in the medium term.

Factors that Could Lead to an Upgrade

One or a combination of the following could have positive rating implications:

- Operating margins remaining strong over 35%
- Social housing letting interest cover comfortably sustained above 1.5x
- Debt falling below 40% of assets at cost

Factors that Could Lead to a Downgrade

Negative pressure could be exerted on the rating by one or a combination of the following:

- Underperformance of its market sales leading to increased borrowing or weaker liquidity
- Failure to successfully implement the efficiency programmes with margins lower than anticipated
- A weaker regulatory framework, a dilution of the overall level of support from the UK government or a downgrade of the UK sovereign rating

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 2

Clarion Housing Group Limited

	31-Mar-16	31-Mar-17	31-Mar-18*	31-Mar-19*
Units under management (no.)	121,713	122,463	123,573	123,445
Operating margin, before interest (%)	32.6	31.1	34.4	32.3
Net capital expenditure as % turnover	6.9	17.3	34.4	62.1
Social housing letting interest coverage (x times)	1.6	1.5	1.6	1.6
Cash flow volatility interest coverage (x times)	2.0	2.1	2.2	2.2
Debt to revenues (x times)	3.5	4.0	4.4	3.8
Debt to assets at cost (%)	48.5	47.7	47.4	47.6

All figures are FRS 102 compliant, FY2016 and FY2017 are from audited financial statements and FY2018-FY2019 are forecasts
Source: Moody's Investors Service, Clarion Housing Group

Detailed Rating Considerations

Clarion's A3 rating combines a baseline credit assessment (BCA) of baa1, with (1) our assessment of the very high default dependence between the group and the UK government and (2) a strong likelihood of extraordinary support in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

One of the largest housing associations in the UK

Clarion is one of the country's largest providers of social housing which underpins its financial resilience. Clarion had 122,463 units under management as of 2017 year end, with operations spread nationwide across 185 local authorities. Clarion's sizeable balance sheet, including a £6.5 billion net book value of Clarion's housing properties in FY2017, supports increased capacity to deal with uncertainties compared with smaller housing associations.

Larger organisations also tend to have higher expenditure flexibility with room to increase operating efficiency, and the ability to take advantage of economies of scale during economically challenging times. The merger of Affinity Sutton and Circle, completed in November 2016 to form Clarion, has the potential to bring about additional efficiencies in the form of procurement savings, efficiencies in management costs and a proactive asset management strategy.

Clarion is currently in the process of implementing their *"FF2 business change programme"*, which is targeting full harmonisation of operational processes across the group. Pre-merger, Affinity Sutton's management team had a strong track record of driving efficiencies which contributed to higher operating profitability and lower cost per unit. Over the next three years, the group's operating costs per unit is expected to become increasingly aligned with the cost per unit of the former Affinity Sutton as opposed to Circle, whose costs per unit were higher.

The substantial size of Clarion results in a strong market position and affords it more political influence than smaller peers. Its size is also a benefit when competing for development opportunities.

Stable operating margin and interest cover

Clarion's profitability and interest cover ratios will remain stable going forward, a credit strength. Clarion's operating margin was 31% in FY2017, in line with the 32% median of its A3-rated peers. Operating margins going forward are anticipated to strengthen slightly, averaging 33% over the next three years.

Despite the anticipated high (>20% of turnover) exposure to market sales activity and forecast increase in debt, Clarion's interest cover ratios will remain stable in line with peer medians over the medium term. Social housing letting interest cover (SHLIC) was

1.5x in FY2017, and is anticipated to remain broadly at this level over the next three years. This is, however, contingent on the group being effective in reducing its cost base on social housing assets and subsequently increasing their social housing letting operating profitability from 35% in FY2017 to 44% by FY2020.

Cash flow volatility interest cover (CVIC), which incorporates cash movements in market sales activity both in cash spent on stock and in sales receipts, was slightly above the A3-rated peer median in FY2017 and will also remain stable over the next few years. Clarion's CVIC in FY2017 was 2.1x compared to a rated peer median of 1.8x, and will remain stable averaging 2.2x over the next three years.

Solid liquidity position supported by strong unencumbered assets and robust treasury policy

Clarion has a solid liquidity position, supported by strong unencumbered assets, which partially mitigates the risks associated with its business model of large-scale development. Immediately available liquidity, represented by cash and readily available undrawn facilities, was £976 million at FYE2017, sufficient to fund 1.2x its two-year net capital requirements. As of August 2017, Clarion had unencumbered assets of £1.8 billion, including £1 billion of charged but unallocated assets in its main shared security pool structure.

Favourably, Clarion's management places an importance on liquidity with a strong policy which is bespoke to the business risk of the organisation. The policy is to hold the greater of £150 million in cash, or a sum equal to the next three months' gross committed development spend. Furthermore, Clarion's liquidity policy states that the current policy is to hold sufficient liquidity to cover requirements for the next 18 months including scheduled debt repayments, reducing sales income and excluding land banking.

Furthermore, Clarion's management demonstrates its commitment to the financial strength of the organisation through its adherence to its financial Golden Rules, similar to those the former Affinity Sutton had on a standalone basis for more than ten years. The rules for the Group include: (1) interest cover (Earnings before interest, taxes, depreciation, amortisation over net interest paid) over 1.5x; (2) maintaining an operating margin above 30%; (3) limiting net debt growth to 4.0x revenue (4.5x in FY2018); and (4) keeping market sales exposure under 40% of turnover (excluding regeneration).

Strong regulatory framework

The sector's credit quality will continue to benefit from the strong regulatory framework and oversight by the Homes and Communities Agency (HCA). The HCA maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and undertaking In-Depth Assessments of entities where deemed necessary. Additionally, the HCA has powers to make board member and manager appointments where there has been a breach of Regulatory Standards . From October 2017, the HCA will charge fees for social housing regulation, as a means of enhancing the independence and maintaining the effectiveness of the regulator.

Increasing exposure to market sales

Clarion's exposure to market sales will increase materially over the next three years, which will impact the predictability of its revenues and introduce new risks to the organisation. We define a high level of market sales exposure as a level more than 20% of revenue, which Clarion will reach in FY2019. Market sales as a percentage of revenue will increase to 33% by FY2020, up from 9% in FY2017.

The shift toward a high exposure to market sales from a moderate exposure has the potential to add volatility to Clarion cash flows and complexity to its operations. Moreover, housing associations with larger development programmes are more susceptible to development risks, which can include: speculative building and buying, landbanking strategies, unexpected increases in build costs and/or labour shortages and unpredictable revenues from market sales activity.

Balanced against these risks is Clarion's experience in delivering development projects, its rule that all contracted development will be covered by cash or immediately available facilities, and that the bulk of market sales beyond FY2019 are aspirational and currently uncommitted. Clarion also has the ability to change tenure from private sale to private rent (though this would materially affect cash flows); and there is also no reliance on sales to cover interest costs.

Clarion's market sales are delivered through its commercial arm, Latimer, which is designed to generate profits to be distributed to the Group. Latimer contains activities related to private market rent, development for sale and other market services. The planning assumption for Latimer is to eventually be funded through 40% equity/subordinated debt from the Registered Provider (RP) within the group and 60% external debt on a non-recourse basis.

Merger consolidation challenges, but positive progress on group structure

Despite Clarion's history of mergers, there are challenges with execution and integration of two large entities. There is a risk that the £38 million of expected merger savings will not be fully realised or be realised less quickly than anticipated. While efficiencies may eventually be realised, the restructuring and escalation of the entity's development programme over the near to medium term, restructuring and integration of the two entities will require significant resource from the organisation.

Clarion planned to simplify the group structure as part of the merger process which is credit positive and as of December 2017, nearly complete. Coming into the merger, Circle had a complex group structure which included 16 main trading entities in the Circle group of which 10 were registered providers. Post-merger, Clarion has continued the exercise of collapsing the nine registered asset holding subsidiaries (formely of Circle) into one registered provider (RP), leaving two registered providers at the end of the restructuring. Clarion's end goal, which is likely to complete in Q1 2018, is to collapse the RPs of the legacy Circle and Affinity Sutton groups into one, Clarion Housing Association Limited. Going forward, we expect that Clarion's simplified group structure will positively impact management's ability to allocate financial resources more efficiently.

Increasing debt in the medium term, but debt metrics stable

Clarion's debt will increase over the next few years, but debt metrics are expected to remain broadly stable. Clarion's total debt was £3.3 billion at FYE2017, equivalent to around 4.0x revenues and 48% of assets at cost (gearing), which was below A3-rated peers' respective medians of 4.3x and 54%. To fund its ambitious development programme over the next three years, Clarion's debt will increase to £4.2 billion by FYE2020. However, reserves will also grow resulting in stable gearing averaging 48% over the next three years.

The forecasted stable debt metrics are contingent on market sales surpluses being realised as planned, as well as execution of a substantial asset disposal programme which will generate £2.9 billion in proceeds over the next ten years. Clarion's intention with its asset disposal programme is to both sell social housing assets to other RPs and realise proceeds from void sales. Clarion's development programme is underpinned by the forecast cash flows from market sales receipts and asset sales. If they fail to materialise, the group would recalibrate its development ambition accordingly.

In September 2017, Clarion established a £3 billion secured Euro Medium Term Note (EMTN) Programme which will be used to fund development, to refinance existing facilities, and to diversify its investor base.

Operating environment remains challenging but policy is more stable

Moody's does not expect additional material adverse policy shifts for the sector and considers the operating environment to be stable in the medium term. Adverse policies announced in the last few years will continue to negatively impact revenues, especially the effects of the 1% annual decrease in social rents (until FY2020) and Universal Credit (a pillar of broader welfare reform measures). However, HAs have demonstrated resilience to adverse policies to date and been proactive to mitigate the impact. A reduction of capital grant for new social housing over the last five years has led to increased exposure to market sales activity, which has more than doubled since 2012 to reach 17% of turnover for Moody's rated HAs in FY2016. Credit risk association with exposure to market sales is incorporated in BCAs.

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 (Aa2 stable) is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support assumption also factors increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more challenging. In addition, our assessment that there is a very high default dependence between Clarion and the UK government reflects their strong financial and operational linkages.

Rating Methodology

European Social Housing Providers, July 2016 (190944)

Government Related Issuers, August 2017 (1047378)

Ratings

Exhibit 3

Category	Moody's Rating
CLARION HOUSING GROUP LIMITED	
Outlook	Stable
Issuer Rating -Dom Curr	A3
CLARION FUNDING PLC	
Outlook	Stable
Senior Secured MTN -Dom Curr	(P)A3
CIRCLE ANGLIA SOCIAL HOUSING PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3
AFFINITY SUTTON CAPITAL MARKETS PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3
CIRCLE ANGLIA SOCIAL HOUSING 2 PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

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