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13 March 2017

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RATINGS

Clarion Housing Group Ltd

Domicile	United Kingdom
Long Term Rating	A2
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

KEY METRICS:

	31/3/15	31/3/16	31/3/17F
Units under management	57,794	129,885	124,259
Operating margin before interest (%)	38	33	33
Social housing letting interest coverage (x times)	2.3	1.7	1.5
Debt to revenues (x times)	2.8	3.5	4.3
Cash flow volatility interest coverage (x times)	2.8	1.8	1.1

**FY2015 calculated using Affinity Sutton's accounts; FY2016 calculated using combined Affinity Sutton and Circle accounts; FY2017F projections based on Clarion Housing Group*

Source: Clarion Housing Group, Moody's calculations

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Clarion Housing Group Limited

Growth Ambitions Will Increase Debt, Exposure to Market Sales

Clarion Housing Group (CLH, A2 negative), formed through the merger of Affinity Sutton Group (ASG) and Circle Housing Group (CIR), outlined its strategy and growth ambitions on merger. These include plans to markedly increase the number of properties it builds, including additional market sale properties to subsidise development of affordable housing units through profits from outright sales. The transformative merger and increased development and growth ambitions will mean higher debt, lower interest covers as well as a higher exposure to market sales.

» **Growth ambitions drive business plan with increased sales exposure, higher debt**: Amid reduced capital grants, government-imposed rent cuts and political pressure for increased house-building, several mergers in the sector have been announced with intentions to increase development, leveraging larger combined balance sheets. Similarly with its recent merger, CLH plans to increase construction of housing units to 50,000 over a decade from FY2020-21 funded in part by an increase in outright sales activity to help cross-subsidise the development of social housing units. This is higher than the two organisations' pre-merger plans, and the stepped up development program will increase CLH's exposure to open market sales and development risks and result in higher debt, higher net capital expenditure, increased cash flow volatility and lower interest covers. Tempering some of these risks and supporting the A2 rating are CLH's good liquidity, supported by strong unencumbered assets, and management's creation of financial Golden Rules.

» **Sizeable balance sheet to provide greater financial resilience**: Upon its official formation on 29 November 2016, Clarion became one of England's largest housing associations (HAs) with around 125,000 units under management. The new entity will have a sizeable balance sheet, providing greater resilience to financial stresses. The larger size could also provide some political and market influence.

» **Transformative merger brings new structure, strategy**: The merger brings together two large entities with differing credit metrics and creates a new corporate structure and brings a change in strategy. ASG had stronger credit metrics than CIR before the merger, while CIR had a large proportion of social housing lettings in total revenues but a more complex corporate structure. CLH's corporate structure incorporates a separation of the registered providers and a new commercial arm, and brings a new strategic direction with the emphasis on increasing development and cross-subsidising the building of social housing units through profits from its commercial arm.

Growth ambitions drive business plan with increased sales exposure, higher debt

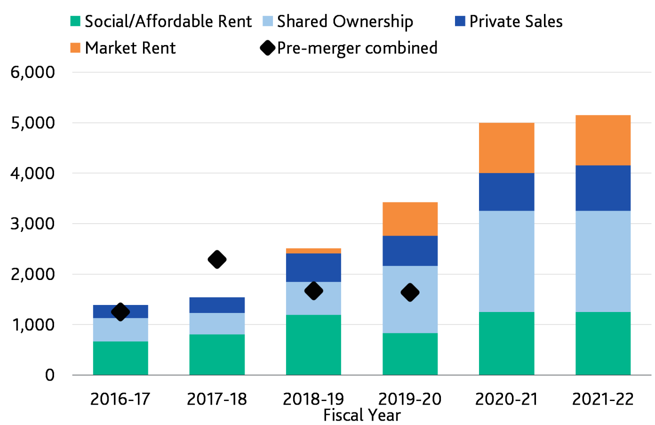
Amid reduced capital grants, government-imposed rent cuts and political pressure for increased house-building, there have been several recent mergers and announcements of mergers in the sector with intentions to increase development, leveraging larger combined balance sheets. Announced and executed mergers in the last year that incorporated increased development intentions (on varying scales) include: Affinity Sutton Group and Circle (now Clarion, A2 negative); L&Q Group and East Thames Group (now L&Q, A2 negative); Peabody (A3 negative) and Family Mosaic (A1 negative); and AmicusHorizon Limited (A2 negative) and Viridian (unrated).

On 29 November 2016, Clarion Housing Group Limited (CLH) was officially formed following the merger of Affinity Sutton Group Limited (ASG) and Circle Housing Group (CIR) with the transfer of engagements of Circle Anglia Limited (the parent company of Circle Housing Group) to Affinity Sutton Group Limited. Affinity Sutton Group Limited was renamed Clarion Housing Group Limited.

With its recent merger, CLH plans to increase construction of housing units to 50,000 over a decade from FY2020-21 funded in part by an increase in outright sales activity to help cross-subsidise the development of social housing units. This compares with the two organisations' pre-merger plans to develop a combined 1,740 units per year over the period FY2016-20.[1]

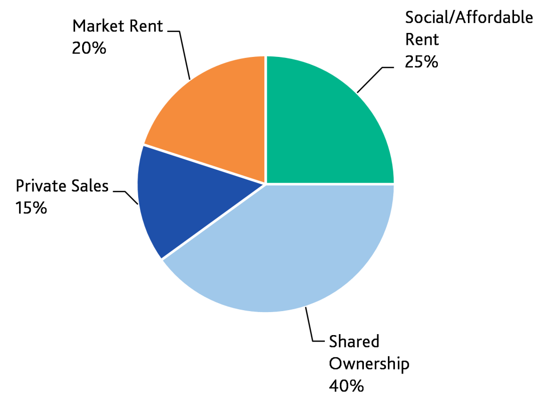
The increase in development will ramp up over the next few years with around 5,000 units planned in FY2021 (see Exhibit 1). At this point, the tenure mix will broadly be 25% social/affordable rent, 20% market rent, 15% private sales and 40% shared ownership (which would also entail an outright sales component); a lower proportion of social/affordable rent and higher shared ownership and private rent than the combined pre-merger development plans over FY2016-20 (Exhibit 2).

Exhibit 1
Development plans higher after merger
Number of units planned to be developed



*Projections
Source: Affinity Sutton, Circle Housing, Clarion Housing Group, Moody's calculations

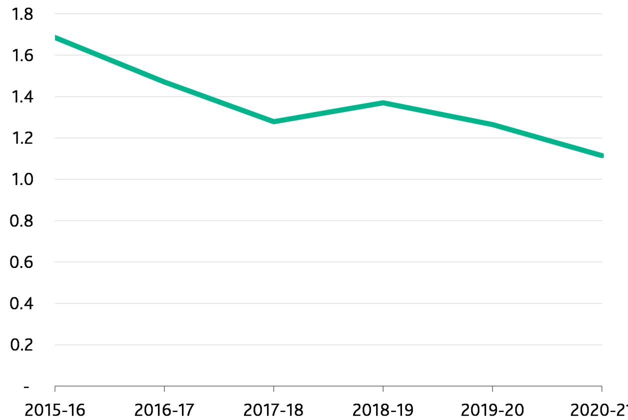
Exhibit 2
Clarion's planned tenure mix increases proportion of market rent and shared ownership by FY2020-21



*Projections
Source: Clarion Housing Group, Moody's calculations

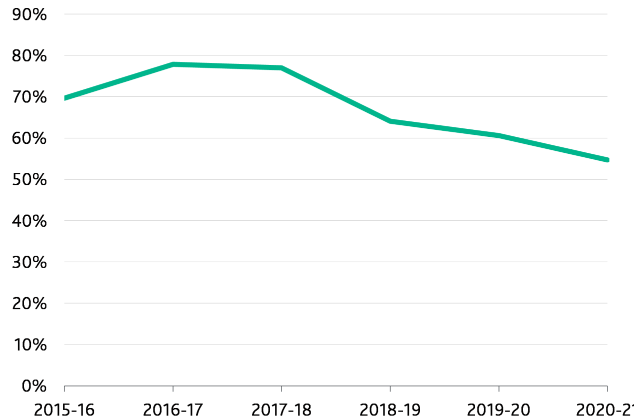
The stepped up development program will increase CLH's exposure to open market sales and development risks and result in higher debt, higher net capital expenditure (capex), increased cash flow volatility and lower interest cover. To fund its development programme over the next five years, CLH's debt will increase to £4.8 billion by FYE2021, from £3.3 billion at FYE2016. As a result, debt to revenues and gearing will increase and peak in FY2018 at 4.5x and 47%, respectively (in line with the Golden Rules discussed below). Asset sales are also planned to generate cashflows for development, with social housing units planned to be sold to other housing associations. As debt increases, social housing letting interest cover (SHLIC) will fall and average 1.3x over FY2017-21, from 1.7x in FY2016 (Exhibit 3).

Exhibit 3
Social housing letting interest cover is projected to decline



*Combined Affinity Sutton and Circle FY2016 and Clarion projections from FY2017
Source: Affinity Sutton and Circle financial statements, Clarion Housing Group, Moody's Calculations

Exhibit 4
Share of social housing letting in turnover will fall



*Combined Affinity Sutton and Circle FY2016 and Clarion projections from FY2017
Source: Affinity Sutton and Circle financial statements, Clarion Housing Group, Moody's Calculations

CLH's plans will lead to increased market sales activity that will be substantial relative to its peers. As a result, the relatively lower-risk social housing letting income will decline significantly relative to turnover, falling to 55% in FY2021 from 70% in FY2016 (Exhibit 4). Sales revenue is projected to account for 42% of turnover in FY2021. However, operating margins are projected to remain robust, averaging 32% over FY2017-21. Assuming that merger savings are achieved and the social housing letting business remains very profitable, SHL margins are projected to average 36% over the same period (FY2017-21). Total margins are also expected to be high and average 33% over FY017-21. However, this also incorporates the expectation of selling social housing units. Clarion anticipates selling roughly 10,000 units by FY2025. Should asset sales not materialise as expected, margins may be lower than projected and management would plan to scale down development plans, in keeping with their financial Golden Rules.

High exposure to sales also has the potential to add volatility to CLH's cash flows and complexity to its operations. Moreover, HAs with larger build programs are more susceptible to development risks, which can include: speculative building and buying, land banking strategies, unexpected increases in build costs and/or labour shortages and unpredictable revenues from market sales activity. CLH plans to acquire land in a land bank to feed its development pipeline. CLH incorporates a planning assumption of roughly four years from land purchase to eventual market sale, and hence the lead time to FY2021 to build up to 5,000 units. While this would require holding land for a period of time, it does provide some flexibility in adjusting spending planned for these purposes.

Balanced against some of these risks is CLH's experience in delivering development projects, although we note that the scale will be ramped up with a required increase in capacity.[2] There are a number of other factors that temper these development risks, including: that all contracted development would be covered by cash or immediately available facilities; the bulk of sales projected for FY2017-21 are aspirational and still to-be-committed, with CLH having the ability to scale them down if market conditions deteriorate; the ability to change tenure from private sale to private rent (although this would affect cash flows); and that there is no reliance on sales to cover interest costs. The business plan also assumes profit from sales at 20%, which is lower than recently achieved by CIR and ASG.

Moreover, CLH's management places an importance on liquidity. The current policy is to hold the greater of £150m in cash, or a sum equal to the next three months gross development spend (November 2016: £100m). Operating cash held at November 2016 month end was £222m. Furthermore, CLH's draft liquidity policy includes holding sufficient liquidity to cover requirements for the next 18 months including scheduled debt repayments, reducing sales income and excluding land banking. We view this as a strong policy and as a credit positive.

Management's commitment to the financial strength of the organisation is demonstrated by the creation of financial Golden Rules, similar to those the former ASG had on a stand-alone basis for more than 10 years (Exhibit 5). The former ASG had a track record of abiding by their Golden Rules, and we expect that CLH management will continue this. We view management's adherence to these Golden Rules positively in terms of financial management.

Exhibit 5
Clarion's Financial Golden Rules

Financial Golden Rules	Full Group	RP Group	Latimer
EBITDA MRI Cash Interest Cover	>1.5x	>1.5x	>1.5x
Operating Margin	>30%	>35%	
Net Debt/Turnover - FY2018	<4.5x		
Net Debt/Turnover - FY2019 onward	<4.0x		
Sales as % of Turnover	<40%		
Social Housing Interest Cover		>1.3x	
HA Investment as % of Revenue Reserves		<20%	
Sales WIP			<£600m
Value at Risk Coverage			>1.5x

*Calculations may differ from Moody's calculations
Source: Clarion Housing Group

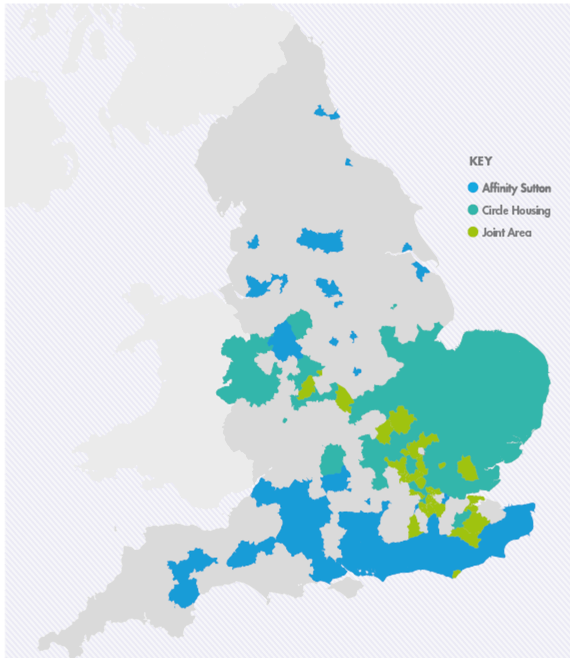
Sizeable balance sheet to provide greater financial resilience

ASG and CIR were relatively large housing associations in their own right with approximately 58,000 and 64,000 units respectively at FYE2016.[3] Upon the merger, Clarion Housing Group became one of the largest housing associations in England with around 125,000 units under management. Operations are spread nationwide across 176 local authorities, where demand for social housing is generally high (see Exhibit 6). At FYE2016, the combined housing assets of the two former HAs, net of capital grants, was £4.2 billion. This figure is projected to increase to £6.2 billion by FYE2020. This gives the new entity a sizeable balance sheet with an increased capacity to deal with uncertainties and provides greater resilience to financial stresses. The larger size could also provide some political influence in housing policy as well as market influence, for example in terms of competitiveness and the ability to develop larger scale sites.

Exhibit 6

Location of Clarion Housing Group properties

Operations spread nationwide



Source: Clarion Housing Group

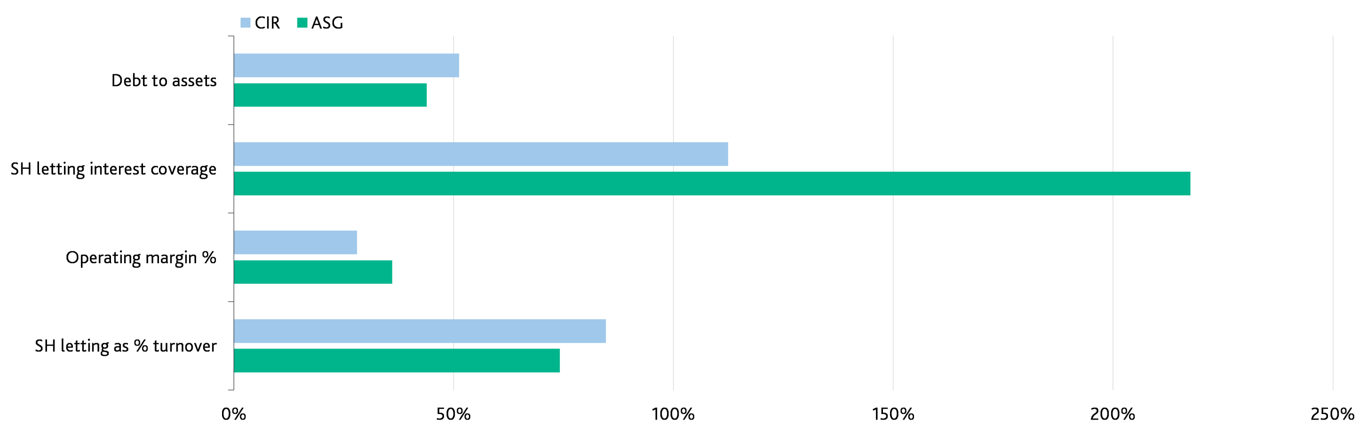
Transformative merger brings new structure, strategy

The merger brings together two large entities with differing credit metrics, creates a new corporate structure and brings a change in strategy. ASG had stronger credit metrics than CIR before the merger. ASG's margins were higher, debt was lower and social housing letting interest cover was stronger. CIR had a large proportion of social housing lettings in total revenues but a more complex corporate structure.

Exhibit 7

Affinity Sutton had generally stronger credit metrics than Circle prior to merger

Average FY2011-12 to FY2015-16



* Moody's calculations

Source: Affinity Sutton Group and Circle Financial Statements, Moody's calculations

Changing group structure

At FYE2016, ASG's group structure consisted primarily of a single HA (Affinity Sutton Homes Limited) and a number of other subsidiaries all under Affinity Sutton Group Limited. In contrast, CIR had a relatively complex group structure with 16 main trading entities in the Circle group of which 10 were registered providers. This Group structure added complexity to governance and management. The parent of Circle, Circle Anglia Limited, which was one of the 10 registered providers, had effective control over all subsidiaries by board appointment.

In parallel with the merger, CIR is presently restructuring to collapse the nine registered asset holding subsidiaries into one registered provider (RP), leaving two RPs at the end of the process. The amalgamation continues through merger and should be largely completed by Q2 2017. At merger, two Circle subsidiaries had collapsed into Circle 33, with seven Circle RPs at merger (excluding Circle Anglia). Eventually, post-merger, all the Clarion RPs will be consolidated into a single RP under the Group parent.

The new corporate structure of CLH differs significantly from the previous structures of ASG and CIR. In particular, there is a separation of the core social housing landlord business and the creation of a commercial arm designed to generate profits to be distributed to the HA/RP Group.

CLH's new corporate structure comprises the Group parent, Clarion Housing Group, which is a non-asset owning HA with charity status and two business subsidiaries: the HA subsidiary, which holds the core social housing landlord business, and a new commercial arm. While the current structure of CLH contains an amalgamation of the former ASG and CIR entities, including seven HAs, the eventual structure will be more streamlined (Exhibit 8). The commercial arm, also known as Latimer, will contain activities related to private market rent, development for sale, care and support activities and other market services. In addition, under the Group parent, there is a charitable subsidiary and the funding vehicles.

Exhibit 8
Clarion Group Structure will be simplified

*Simplified eventual structure
Source: Clarion Housing Group

CLH is seeking to leverage its larger balance sheet to support growth by generating profits from its Latimer arm to redistribute to the HA subsidiary to cross-subsidise the construction of new affordable homes. The division of CLH into an RP arm and a commercial arm seeks to separate the RP business from the commercial business with an intent to separate the risks, although the parent, CLH, has effective control and oversight over the entire organisation and there is no legal impediment to funds flowing from one part of the organisation to another. Latimer will initially be funded through equity or subordinated debt from the HAs with the planning assumption to eventually fund Latimer through 40% equity/subordinated debt from the HAs and 60% external debt on a non-recourse basis to the rest of the organisation. It will also build up reserves as profits are recorded. Latimer also has its own Golden Rules (as above). Nevertheless, the investment in the commercial arm from the HA arm will be significant with an initial investment of £156 million in FY2017 and a planning assumption to reach almost £1 billion in FY2027.[4]

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Endnotes

1 Clarion presently plans to develop around 2,770 units per year over FY2017-21, as it gradually builds up its development pipeline.

2 Circle has previously delivered 1,142 in a single financial year and ASG 1,428.

3 Excluding garages.

4 With the majority of this investment assumed to be funding a private rental portfolio.

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