MOODY'S
PUBLIC SECTOR EUROPE

Credit Opinion: Affinity Sutton Group Ltd

Global Credit Research - 27 Apr 2016

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Aa3

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Key Indicators

Affinity Sutton Group Ltd

	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
Units under management (no.)	56,103	56,107	56,467	56,856	57,794
Housing assets (GBP million)	1,316	1,428	1,527	1,674	1,785
Operating margin, before interest (%)	32.6	33.3	35.0	38.2	38.5
Net capital expenditure as % turnover	27.9	37.9	22.4	38.1	-4.3
Social housing letting interest coverage (x times)	1.9	1.9	1.9	2.1	2.4
Recurrent cash interest coverage (x times)	2.4	2.4	2.5	2.7	3.5
Debt to revenues (x times)	4.2	4.3	4.0	4.1	3.0
Debt to assets at cost (%)	43.4	45.0	44.5	45.2	42.3

Opinion

SUMMARY RATING RATIONALE

The Aa3 issuer rating assigned to Affinity Sutton Group (ASG) reflects (1) strong and stable cash flows from low-risk social-housing letting; (2) moderate and declining indebtedness; (3) robust governance and strong financial discipline; and (4) modest capital expenditure going forward. The rating also takes into account ASG's rising exposure to sales and higher exposure to interest rate risk relative to rated peers.

The Aa3 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 stable) would intervene in the event that ASG faced acute liquidity stress.

ASG is rated at the upper end of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. ASG's relative position reflects strong and stable margins, high interest coverage ratios, higher flexibility due to considerable amount of liquidity and unencumbered assets, but also rising sales and higher exposure to interest rate risk.

Credit Strengths

Credit strengths for ASG include:

- Very high and stable operating margins and interest coverage ratios

- Strong liquidity position supported by ample unencumbered assets and modest debt levels going forward

- One of the largest housing associations in the UK with robust governance and strong presence in the South East of England

- Strong regulatory framework

Credit Challenges

Credit challenges for ASG include:

- Sharp increase in planned income from outright sales, which adds complexity to operations and might increase cash flow volatility

- Government policy changes make operating environment less predictable and more challenging for housing associations

Rating Outlook

The outlook on ASG's rating is stable factoring a continuation of the association's strong financial performance in FY2015 coupled with a strong liquidity position. We also take into account ASG's willingness to mitigate the impact of the policies announced in the UK Summer Budget 2015 on its financial performance and profile, as outlined in its revised business plan. Our view that ASG has a management capacity to cope with the policy changes is also supported by its very strong track record of extracting efficiencies and improving operating performance.

What Could Change the Rating - Up

Whilst unlikely in the near term given ASG's increased engagement in market sales activity, one or a combination of the following could have positive rating implications: (1) continuous strengthening of operating margins above 40% of turnover and social-housing-letting interest coverage ratio above 2.5x; (2) debt structurally falling below 3.5x revenue or 40% of assets at cost; (3) a reduced exposure to outright sales activity, which has a potential to increase cash flow volatility.

What Could Change the Rating - Down

Negative pressure could be exerted on the rating by one or a combination of following: (1) underperformance of its development-for-sale schemes resulting in deterioration of ASG's currently strong liquidity position; (2) significant weakening in its operating margin from core activities; (3) a decline in its social housing letting interest coverage structurally below 1.7x; (4) debt levels structurally above 5x revenue; (5) weaker liquidity position, which would impact ability to meet future refinancing requirements; and/or (6) a failure to effectively address the future loss of revenue from the recent UK budget announcement. 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

ASG is planning to merge with Circle (CIR, A2 stable), with the merger expected to be completed by Summer 2016. In March 2016, CIR and ASG announced the appointment of the shadow executive and board team. The combined entity would become one of Europe's largest housing associations with 127,000 units under management and is expected to deliver 5,000 new homes annually from FY2021. While discussions between ASG and CIR predated the July Budget 2015 announcements (discussed below), the policy changes have enhanced both boards' appetites to escalate the merger. Though merger arrangements are still being determined, a significant increase in development aspirations of the combined entity could increase exposure to development risk and increase reliance on the housing market, which would be credit negative. The rating assigned in this credit opinion speaks to the financial strengths and future projections of ASG as a standalone entity.

In April 2016, ASG released its financial update for the final quarter of FY2016. The update showed financial performance strongly ahead of budget with the management accounts reporting a net surplus of GBP141.6 million, some GBP42 million ahead of forecasted position. Performance was supported by strong results in its build-for-sale activity and lower interest rates. These results are unaudited.

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

ASG's rating combines (1) its baseline credit assessment (BCA) of a2, and (2) a strong likelihood of extraordinary support coming from the UK government in the event that ASG faced acute liquidity stress.

Baseline Credit Assessment

VERY HIGH AND STABLE OPERATING MARGINS AND INTEREST COVERAGE RATIOS

ASG's operating margins have averaged 36% of turnover over the last five years, well above the 27% average of its rated peers over FY2011-15. The strong margins were primarily due to efficient cost control measures, realised economies of scale and solid and improving rent collection rates. The association's operating margin improved to 39% of revenues in FY2015 from 38% in FY2014, the FY2015 median of rated peers was 28%. ASG's total margin (before tax) recorded a strong growth to 29% of revenues in FY2015 from 23% in FY2014 due to a significant increase in built-for-sale activity, which recorded a healthy margin of 27%, stronger staircasing sales, and a one-off disposal of student accommodation units as part of a stock rationalisation programme.

ASG's social-housing-letting interest-coverage ratio (including depreciation, SHLIC), a measure of the organisations ability to cover interest costs from low-risk activities, strengthened significantly to 2.4x in FY2015 (2014: 2.1x) and remained among the highest within the Moody's rated peers (FY2015 median: 1.3x). The improvement was driven by a stronger margin on social-housing lettings coupled with stable interest costs. ASG's cash interest coverage ratio (CIC), which measures the entities ability to pay interest from operating cash flow, doubled to 4x in FY2015 (FY2014: 2x), the result of strong performance from ASG's outright sales programme. The continual strengthening of the SHLIC ratio over the last 5 years is something that we view as credit positive, it demonstrates the organisations improved ability to service its debt from the low-risk activities despite increases in debt to finance the development pipeline, which included outright sales units. We note, however, that ASG's coverage ratios continue to benefit more strongly from the current low-interest-rate environment than those of rated peers as the association held 24% of its debt at variable rates (30 September 2015), above the latest median of its rated peers of 17%. Although the variable rate exposure is higher than that of rated peers, it has since declined to 18% as of March 2016 and is well within ASG's treasury policy target of between 15% and 35%.

With the announced rent cut, ASG expects that by FY2020 an ongoing annual shortfall in social housing rental income compared to the pre-announcement position is around GBP38 million. The business plan figures quoted in this report incorporate the effect of the rent reduction and other announced policies as well as the mitigating measures that ASG plans to implement. The key aspects of the mitigation plan are: (1) a reduction in core development programme, (2) some increase in market sales and inclusion of private rent; and (3) setting rents on some of its properties closer to Affordable Rent. Although ASG's already high operating margin provides limited potential for generating substantial operating efficiencies, management also decided to accelerate its ongoing cost rationalisation programme, which now aims to deliver more savings over four years starting FY2017 than the pre-announcement plan.

ASG projects that its operating margin will remain at a solid 38% of turnover in FY2015/16 and FY2016/17, followed by a gradual weakening to 32% by FY2020, a consequence of the rent reduction. Although some of the rent loss will be offset by a continuing focus on the expenditure rationalisation, ASG acknowledges that its operating cost base is already very streamlined thus a reduction in operating expenditures is therefore not a key aspect of its mitigation strategy. Instead, ASG's plans outline a reduction in its development pipeline combined with a change in the tenure mix, this helps limit debt growth and therefore protects ASG's very strong interest cover ratios relative to peers. ASG expects SHLIC to stay at or above 2x and then gradually decline to a still solid 1.6x by FY2020, as a result of declining social housing rental income but also due to an assumption of increasing LIBOR. Although the cash interest coverage shows some signs of increased volatility over the next five years as a result of ASG's increased engagement in market sale activity, it is projected to remain between 1.9x and 3.5x, evidencing no reliance on asset disposals or borrowings to cover interest costs.

STRONG LIQUIDITY POSITION SUPPORTED BY AMPLE UNENCUMBERED ASSETS AND MODEST DEBT LEVELS GOING FORWARD

ASG enjoys a strong liquidity position, supported by an abundance of unencumbered assets. Immediately available liquidity, represented by cash and readily available undrawn facilities, was GBP532 million at the end of September 2015. It is equivalent to 124% of revenues, which is well above the latest median of Moody's-rated peers (91%). Moreover, it is sufficient to cover net cash requirements (including debt repayment) in ASG's business plan for the next five years, very strong relative to peers. Favourably, ASG's management places an importance on liquidity of its funds and therefore targets a minimum cash balance of GBP50 million at all times (GBP54 million as of September 2015). All of ASG's borrowing facilities are currently secured and immediately available. Unencumbered assets, valued at almost GBP786 million at Exiting Use Value for Social Housing as at 30 September 2015 (net of collateral required for swap contracts), could provide additional liquidity of around GBP748 million, which is equivalent to approximately 174% of ASG's revenue and in line with the current rated peers median of 171%.

ASG's debt slightly declined to GBP1.3 billion at FYE2015 from 1.32 billion in FY2014 as a result of outright sales proceeds being used to repay one of ASG's revolving facilities. The debt at FYE2015 was equivalent to around 3.0x revenues and 42% of assets at cost (gearing), which is below rated peers' respective medians of 4x and 47% in FY2014. ASG's relative indebtedness has declined significantly in FY2015 from 4.1x and 45% respectively at FYE2014, primarily as a result of a planned, material increase in turnover and surplus from outright sales. The decline followed a four-year period of fairly stable relative indebtedness driven by a comparatively moderate and stable investment programme, with net capex averaging around 24% of revenues over 2011-2015. The negative net capex of -4.3% in FY2015 means that ASG generated more cash from operations than it paid out in interest expense and capital expenditure. The strong cash generation reflected a surge in ASG's outright sale activity in FY2015 (see "Sharp increase in planned income from outright sales, which adds complexity to operations and might increase cash flow volatility").

Over the next five years, ASG debt to revenue ratio is anticipated to remain relatively stable at around 3x turnover, while gearing is projected to gradually decline to 39% by FY2020. Both of these measures in ASG's revised plan are lower than anticipated in ASG's previous business plan, as a result of ASG decision to significantly scale down its development programme, approximately by 20%, to mitigate the impact of the rent reduction on its interest coverage and debt service ratios. The reduction came exclusively from the social housing portion of the development pipeline, while the number of outright sales units was slightly increased. ASG also added approximately 1,750 units intended for private rent, but the tenure might be changed according to market conditions. The reduction in development programme results in next capex averaging only 8% of turnover over the next five years. To co-fund its capex and refinance some existing facilities, ASG is considering seeking approximately GBP150 million of new funding in FY2019. ASG's debt portfolio already includes two bullet bonds (both nominal value of GBP250 million), maturing in 2038 and 2042.

ASG's debt covenants include debt service and asset coverage. All covenants are fully met and allow for a solid headroom within ASG's business plan. At FYE2015, 88% of ASG's outstanding debt was due after five years, which was slightly below the average of rated peers. Management makes use of standalone interest-rate swaps for hedging (notional of GBP290 million). At the end of June 2014, these contracts had a negative marked-to-market value of GBP132.9 million. The resulting margin call was fully met by property security. The ample available assets ensure that further margin calls (in excess of 100bps) can be properly met.

ONE OF THE LARGEST HOUSING ASSOCIATIONS IN THE UK WITH ROBUST GOVERNANCE AND STRONG PRESENCE IN THE SOUTH EAST OF ENGLAND

ASG is a large provider of social housing in England, with around 58,000 units under management at March 2015. Operations are spread nationwide across almost 100 local authorities, where demand for social housing is generally high.

ASG's management team has a strong track record in driving efficiencies and delivering on the company's plans. It managed to contain the increase in management costs to only 6% between FY2011-15 while the gross rental income increased by 29% over the same period. Management targets for all key areas were out performed in FY2015, with margins, interest coverage rations and relative indebtedness showing positive variances to budget reflecting ASG's strong financial discipline. We expect that ASG will also meet its financial targets for FY2016 as assumptions underpinning its business plan for FY2016-20 continue to provide a layer of contingency, although slightly lower compared to its business plan for FY2015-19. These include: (i) 3-month London Interbank Offered Rate (LIBOR) of 1.5% in FY2016 and FY2017, rising to 3.75% by FY2020 (0.6% as of April 2016); (ii) management costs, staff costs and repairs & maintenance inflation at 2.3% in FY2016, 0.75% in FY2017 and then rising to 2.5% by FY2019. To accommodate the possible adverse impact of welfare reform, the business plan assumes (i) bad debts rising to 1.75% of gross rental income in FY2016 and to 3% by FY2019 from 1.2% reported in FY2015; (ii) rent losses from vacant properties rising to 2.0% of gross rental income in FY 2016 and 2.5% by FY 2018 from 1.7% in FY2015. Favourably, ASG's business plan does not incorporate any increase in prices of its properties built for sale, which contributed to ASG achieving stronger-than-planned operating margin in FY2015.

Management's commitment to the financial strength of the organisation is demonstrated by the formation of financial "golden" rules more than ten years ago. The rules, which are regularly reviewed, include: (i) avoiding any reliance on property sales to meet financial obligations; (ii) limiting debt growth to 4x revenue; (iii) maintaining debt service ratio above 1.2x; (iv) intending to keep sales exposure below 40% of turnover, increasing to 50% when including regeneration-related projects; or (v) maintaining minimum level of unallocated unencumbered assets with security trustee of GBP150 million (GBP486 million as of September 2015). Although management recently relaxed the rule limiting sales exposure (previously 30% of turnover), this was offset by tightening of the debt-to-turnover (previously capped at 5x) and debt-service (previously 1.15x) ratios, indicating no significant shift in ASG's comparatively lower risk appetite.

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 emphasises 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.

SHARP INCREASE IN PLANNED INCOME FROM OUTRIGHT SALES, WHICH ADDS COMPLEXITY TO OPERATIONS AND MIGHT INCREASE CASH FLOW VOLATILITY

ASG's revenue grew strongly to GBP430 million in FY2015 from GBP320 million in FY2014, primarily reflecting rising turnover from units developed for market sale (outright and first tranche of shared ownership units). This contributed GBP130 million or 30% of total turnover in FY2015, up from 12% in FY2014 and 13% in FY2013. The FY2015 result was well above rated peers' FY2014 median of 7%. Favourably, ASG's sales performance in FY2015 was very close to its budget, demonstrating good capacity in managing its sales pipeline. Additionally, the association achieved a total sales margin of 27% compared to 22% in its budget.

ASG's business plan indicates that its market sales activity will remain substantial relative to peers, as sales revenue is projected to account for 30% of turnover on average over the FY2016-20 with a peak of 47% in FY2020. We note that high exposure to sales has a potential to add volatility to ASG turnover and complexity to its operations, however, we currently view this position as manageable due to the following factors that significantly mitigate the aforementioned risks: (1) all development for sale is located in London or south-east of England, where the demand remains buoyant; (2) ASG has experience with delivering large-scale development projects; (3) all contracted development is covered by cash or immediately available facilities; (4) bulk of sales projected for FY2016-20 are aspirational and still to-be-committed, with ASG having the ability to scale them down if market conditions deteriorate; (5) sales appraisals do not assume any house price inflation; and (6) there is no reliance on sales to cover interest cost.

However, should ASG report difficulties in developing or selling these units, which would consequently result in a deterioration of projected cash flows, this could exert a pressure on ASG's rating. There is some contingency in the projected cash flows since ASG's business plan assumes an average sales margin of 20%, compared with 27% achieved in FY2015.

GOVERNMENT POLICY CHANGES MAKE 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 these circumstances more challenging. On 8 July 2015, the UK government announced (1) 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%) 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 credit positive 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 (average of 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 ASG's total income, compared to the latest average of 29% for Moody's-rated peers. ASG put in place a range of mitigating measures to respond to Welfare Reform, including (1) proactive management of rent arrears, which improved to 3.7% of gross rental income (current tenants arrears) in FY2015 from 4.0% in FY2014, (2) support for tenants or (3) 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 in the short-term, but creates a risk of a longer term erosion of social housing stock. We do not expect ASG to be significantly impacted by the extension of Right to Buy. The association's preliminary assessment indicates that around 1,700 units could be gradually sold (around 3% of total housing stock under management) as a result of the extension.

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 (Aa1 stable) 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 RIV 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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