MOODY'S
INVESTORS SERVICE

Credit Opinion: Circle - DRAFT - In Progress or Approved Version

Global Credit Research

United Kingdom

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating -Dom Curr	A2
Circle Anglia Social Housing Plc	
Outlook	Stable
Senior Secured -Dom Curr	A2
Circle Anglia Social Housing 2 Plc	
Outlook	Stable
Senior Secured -Dom Curr	A2

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Key Indicators

Circle

	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
Units under management (no.)	**61,378**	**64,978**	**71,370**	**70,478**	**71,049**
Housing assets (GBP million)	**1,937**	**2,040**	**2,082**	**2,152**	**2,269**
Operating margin, before interest (%)	**27.7**	**26.9**	**27.5**	**30.4**	**25.7**
Net capital expenditure as % turnover	**40.5**	**18.8**	**20.7**	**11.9**	**17.9**
Social housing letting interest coverage (x times)	**1.1**	**1.1**	**1.0**	**1.2**	**1.0**
Recurrent cash interest coverage (x times)	**1.5**	**1.7**	**1.6**	**1.8**	**1.7**
Debt to revenues (x times)	**5.1**	**5.2**	**5.1**	**5.0**	**4.8**
Debt to assets at cost (%)	**49.0**	**49.7**	**49.7**	**49.4**	**51.1**

Opinion

SUMMARY RATING RATIONALE

The A2 issuer rating assigned to Circle (CIR) reflects CIR's profile as one of the largest housing associations in the UK and the location of its stock in London and in the South East, as well as the high percentage of revenues from its core social housing letting business which provides it with stable cash flows. It also takes into account CIR's relatively high debt-to-revenue ratio compared with peers, and its social housing letting interest cover ratio, which is lower than rated peers albeit expected to improve as they deliver major efficiency savings to offset negative policy changes.

In addition, the 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 CIR faced acute liquidity stress.

Circle is rated in the middle range of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. Its relative position reflects its solid financial performance, robust balance sheet and cash flows, but also relatively higher debt coupled with lower social housing letting interest cover ratios.

Credit Strengths

Credit strengths for CIR include:

- One of the largest housing associations in the UK, with a complex group structure

- Strong internal controls and liquidity position relative to business plan funding requirement

- Strong regulatory framework

Credit Challenges

Credit challenges for CIR include:

- Increasing percentage of market sales units despite reducing development ambition

- Weak operating margins expected to improve

- High debt levels and weak interest cover, albeit projected to improve

- Government policy changes making the operating environment more challenging for housing associations

Rating Outlook

The outlook on CIR's rating is stable, reflecting its willingness to maintain its financial performance and profile close to current levels despite the financial pressures imposed on the housing association sector by the policies announced in the UK Summer Budget 2015. The factors stated in this report incorporate the updated business plan following the announcement of the UK Summer Budget.

What Could Change the Rating - Up

Upward rating pressure could develop from one or a combination of the following: (1) Social housing interest cover sustained above 1.5; (2) consistent delivery of the business plan and long term efficiency programme.

What Could Change the Rating - Down

Negative pressure could be exerted on the rating by one or more of the following: (1) a change in business strategy to increase non-core commercial activities thereby increasing CIR's exposure to market risks; (2) failure to implement the long term efficiency programme with margins not improving; (3) a deterioration in its social housing-interest cover ratio and a resulting weaker shock absorption capacity; (4) failure to manage a successful resolution to the identified London repair and maintenance backlog; and/or (5) a weaker regulatory framework, a dilution of the overall level of support from the UK government or a downgrade of the UK sovereign rating.

RECENT DEVELOPMENTS

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 making the operating environment more challenging for housing associations" for details. CIR has estimated that rental income will be GBP 50 million less over the next four years than previously forecast as a result of the rent reduction policy. In order to preserve margins and ensure core business strength, CIR has outlined a Fast Forward Circle Programme (FFC) to offset the majority of the rent loss, and we will track the delivery of the outlined FFC.

In addition, CIR are planning to merge with Affinity Sutton Group (ASG, Aa3/Stable), with the merger expected to be completed in the second half of 2016, subject to tenant consultation and relevant approvals and consents.

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 128,843 units under management and we expect the merged entity to deliver 5,000 new homes annually. The boards consider that the merger will provide additional financial capacity through economies of scale that will support this investment capacity. While discussions between Affinity Sutton and CIR predated the July Budget 2015 announcements, 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 CIR as a standalone entity.

On 2 April 2015, CIR's Governance rating was downgraded to G3 from G1 by the HCA. This resulted from notable under-performance of their responsive repairs and maintenance service in two of CIR's nine Registered Provider subsidiaries: Old Ford Housing Association and Circle 33 Housing Trust. CIR have re-allocated GBP 8.4 million in spending over 2015 and 2016 to address the problem and are likely to inject additional resources. The initial mismanagement of repairs raises questions for our assessment of governance, in particular around internal controls. We note however, that key milestones and targets are being met and corrective actions are deemed adequate at addressing previous shortcomings.

DETAILED RATING CONSIDERATIONS

CIR's A2 rating combines (1) a baseline credit assessment (BCA) of baa1 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

ONE OF THE LARGEST HOUSING ASSOCIATIONS, WITH A COMPLEX GROUP STRUCTURE

Circle is the third largest provider of social housing in the UK and the second biggest in London, with 71,049 units under management at FYE2015. Should the merger with Affinity Sutton take place, the merged entity would become one of Europe's largest housing associations with 128,843 units under management. Two thirds of CIR's current assets stem from large stock voluntary transfers (LSVT) or acquisitions of post-stock transfer associations, with the majority of transfers having taken place over the past eight years. As such, some of the LSVTs are relatively new and therefore still fall within their promise periods. CIR's operations are spread across more than 111 local authorities, mainly in the boroughs of Greater London, East Anglia and South East England, where the demand for social housing is high and social housing rents are on average half of market rates. The large number of assets under management also translates into higher revenues of GBP 412 million (compared with a median of about GBP 118 million for Moody's rated UK housing associations).

CIR has an intricate group structure with 16 main trading entities in the Circle group of which 10 are registered providers. This group structure adds complexity to governance and management. The parent, Circle Anglia Limited, which is one of the 10 registered providers, has effective control over all subsidiaries by board appointment. CIR is currently undergoing restructuring to collapse the 9 asset registered asset holding subsidiaries into one registered provider, leaving two registered providers at the end of the restructuring. We expect the amalgamation to be completed by March 2017 with the first 3 of the 9 registered providers amalgamating by July 2016. CIR is currently in talks with their various funders and we will monitor CIR's lender consent development.

STRONG LIQUIDITY POSITION RELATIVE TO BUSINESS PLAN FUNDING REQUIREMENT

CIR has sufficient immediate liquidity in place to cover its two-year net capital requirements. As of November 2015, CIR had cash and cash equivalent reserves of GBP 144 million, as well as GBP 475 million in secured facilities. Combined, this level of capital (GBP 619 million) is equivalent to 150% of turnover, placing CIR above the 91% median of Moody's rated Housing Association portfolio. Its current immediate liquidity of GBP 619 million enables CIR to fund 2.1x its two-year net capital requirements of GBP 301 million, indicating healthy liquidity and no immediate reliance on additional funding to realise their aspirational development programme. In addition, CIR holds a strong unencumbered asset base, potentially granting CIR an additional borrowing capacity of GBP 460 million. CIR also benefits from a prudent treasury policy that requires liquidity to fund the entirety of their uncommitted development cash flow for the next 18 months.

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.

INCREASING EXPOSURE TO MARKET SALES DESPITE REDUCING DEVELOPMENT AMBITION

CIR has over the last 5 years strongly focused their operations on core social housing letting and revenues from social housing lettings from FY2011-2015 averaged 85%, above the A2 peer median of 81%. Recent business plans however indicate that CIR is showing a growing appetite to raise their exposure to open market operations, with first tranche shared ownership sales and outright sales expected to average 5% and 14% of turnover respectively between 2016-2020. As such, this shift towards sales and market rent will increase CIR's exposure to housing market dynamics and is in part a response to the rent reduction policy introduced by the government.

In common with many other HAs, CIR has opted to reduce its total build from a target of 1250 units a year to 1000 units a year while readdressing their optimal tenure mix. Capital expenditure reflects this scaling back, with net capex relative to turnover peaking in 2016 at 27%, and dropping to an average of 16% over the next five years (last year business plan 2014-2019 average: 32%). In delivering a higher percentage of market sales units they are able to observe better the rent reduction impact. Of total aspirational development (4062 units) between FY2016-2020, more than half of the new tenure mix (2169 units) are being allocated as market sales units where the rent reduction is not applicable. New developments intended for shared ownership and outright sales make up 30% and 23% respectively, while the remaining 47% (1893 units) will be added to the balance sheet and enhance CIR's core social housing asset pool. CIR's development ambitions represent an increase of 6% over the next five years from its current portfolio of 71,049 units, a moderate increase albeit with an aggressive tenure mix.

WEAK OPERATING MARGINS EXPECTED TO IMPROVE

CIR posted weaker operating margins in FY2015 at 26%, placing CIR below the 30% median of the A2 rated peer group. CIR's current cost base is higher than G15 peers and includes significant one-off costs due to staff restructuring and their transformation programme. In addition, the governance downgrade in April 2015 has increased maintenance and repairs spend for CIR as it increased expenditure to streamline its repair services and outstanding issues. Repairs and maintenance standards guidelines have now been met as a result of the corrective actions. FY2016 margins are expected at 29%, in line with their FY2011-2015 average operating margin of 28%.

CIR has estimated that rental income will be GBP 50 million less over the next four years than previously forecast as a result of the rent reduction policy announced in the July Budget. In order to preserve margins and ensure core business strength, CIR has outlined steps within its Fast Forward Circle Programme (FFC) to offset the rent loss. FFC is expected to deliver GBP 46 million in savings by FY2019 along with a reduced spend on repairs and maintenance and business transformation services. Activities that drive the FFC saving include closure of offices from 18 to 5 and the centralisation of services such as contact centres. Staff restructuring associated with these changes is expected to deliver GBP 9.3 million in savings by FY2017. The savings combined are expected to fully offset the impact of the rent reduction and operating margins are projected to pick up from their current five-year-low of 26% in FY2015 to reach 30% in FY2020 and averaging 29% between FY2016-2020. Furthermore, CIR's plan includes annual provisions for risk and repairs and maintenance of GBP 6.5 million. We will continue to monitor CIR's outlined savings with what they can deliver moving forward. Failure to deliver expected margin improvements will exert downward rating pressure.

Total margin is also expected to improve, averaging 13% between FY2016-2020 from its FY2015 level of 10% (A2 median: 12%). This is due to the Board decision to increase CIR's asset disposal programme due to pressure from funding cuts as well as a more active asset management strategy. Surpluses from asset disposals and staircasing are now expected to average GBP 14 million a year over the next five years, from GBP 5 million in the previous year's business plan, thereby bolstering CIR's bottom line.

HIGH DEBT LEVELS AND WEAK SOCIAL HOUSING INTEREST COVER, ALBEIT PROJECTED TO IMPROVE

CIR's high debt metrics and low interest covers pose a credit challenge for CIR. CIR's debt-to-revenue has fallen to 4.8x in 2015 (FY2014: 5.0x) as a result of record turnover from non-social housing activity (GBP 86m) (FY2014: GBP 40 million). Despite these positive sales receipts, debt-to-revenue remains above the 4.1x median of the A2 peer group. In addition, their low social housing interest cover in FY2015 (1.0x) places it below their A2 rated peer group (1.2x). The most recent business plan indicates an anticipated improvement to 1.3x in FY2016, as social housing surpluses are expected to outpace net interest payment growth. This is largely driven by the aforementioned anticipated operational efficiencies from the Fast Forward Circle programme. It is expected that social housing operating margins will increase from 28% in FY2015, averaging 34% between FY2016-2020. Should the organisation fail to deliver on these operational enhancements and consequently social housing interest cover improvements are not realised, the entity could face downward rating pressure.

Gearing at cost in FY2015 was 51%, a slight increase from 49% in 2014, which is still in line with the 52% of its A2 peer group, reflecting CIR's balance sheet strength. Debt metrics are expected to improve as CIR's overall debt is expected to remain stable. CIR's debt burden is projected to continue decreasing, reaching a low of 4.0x in FY2019 (2016-2020 average: 4.3x) while CIR's gearing will fall to 48% by FY2020 (2016-2020 average: 49%).

GOVERNMENT POLICY CHANGES MAKING THE 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 this environment 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 ties to the government (which we view as credit positive), 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 (median of 84% in FY2014).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 25% of CIR's total income, compared to the latest average of 29% for Moody's-rated peers. CIR put in place a range of mitigating measures to respond to Welfare Reform, including the proactive management of rent arrears, support for tenants, or the promotion of direct debit payments. The possible extension of the Right to Buy to housing association tenants may lead to positive cash inflows in the short-term, but creates a risk of a longer term erosion of social housing stock. CIR's latest business plan does not assume any RtB sales increases as a result of the RtB 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 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 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 CIR 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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