

**Credit Opinion: Affinity Sutton Group Ltd**

Global Credit Research - 18 Sep 2013

United Kingdom

**Ratings**

<b>Category</b>	<b>Moody's Rating</b>
Outlook	Stable
Issuer Rating -Dom Curr	Aa3

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**Key Indicators**

**Affinity Sutton Group Ltd**

	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13
Units under management (no.)	53,552	55,157	56,103	56,107	56,467
Housing assets (GBP million)	2,101	2,150	1,316	1,428	1,527
Operating margin, before interest (%)	25.5	31.8	32.6	33.3	35.0
Net capital expenditure as % turnover	43.6	3.8	27.9	37.9	22.4
Social housing letting interest coverage (x times)	1.6	1.8	1.9	1.9	1.9
Recurrent cash interest coverage (x times)	1.8	2.0	2.4	2.4	2.5
Debt to revenues (x times)	4.2	3.6	4.2	4.3	4.0
Debt to assets at cost (%)	48.8	44.6	43.4	45.0	44.5

**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 debt-to-revenue ratio (net of cash holding); (3) robust governance and prudent budget planning; and (4) moderate capex programme going forward. The rating also takes into account rising, but manageable exposure to sales, and a limited exposure to universal credit.

In addition, 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 ASG faces acute liquidity stress.

ASG is rated at the upper end of Moody's-rated English housing associations, whose ratings span from Aa3 to A3 (with one exception, rated at Baa3). ASG's relative position reflects strong and stable margins, high cash flow coverage, higher flexibility due to considerable amount of liquidity and unencumbered assets, but also rising sales and moderate debt-to-assets ratio.

**Credit Strengths**

Credit strengths for ASG include:

- Strong and stable cash flows from a robust base of low-risk social housing letting, providing for a high coverage of interest
- Comfortable liquidity position supported by abundance of unencumbered assets
- Robust governance and prudent business planning
- One of the largest housing associations in the UK with strong presence in the South East of England
- Strong ongoing support from the UK government, including an effective regulatory framework and the receipt of a significant share of revenue from housing benefit
- Our assessment of a strong likelihood of extraordinary support from the UK government

### **Credit Challenges**

Credit challenges for ASG include:

- Rising, but manageable sales exposure
- Limited revenue flexibility, which is typical for the sector
- Comparatively average exposure to the implementation of welfare reform, which introduces uncertainty to revenues and cash flow

### **Rating Outlook**

The outlook on ASG's rating is stable.

### **What Could Change the Rating - Up**

Whilst unlikely in the near term given ASG's planned development pipeline, one or a combination of the following could have positive rating implications: (1) an operating margin improving to levels above 40% revenues; (2) a social-housing-letting interest coverage structurally exceeding 1.9x; (3) debt falling below 3.5x revenue; (4) a scaling-back in its development-for-sales programme, whilst successfully delivering projected sales in 2014-18; and/or (5) an upgrade of the UK sovereign rating.

### **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; (2) a deterioration in its recurrent cash-interest coverage below 1.5x; (3) a reliance on sales to cover its interest costs; (4) debt levels that remain above 5x revenue; and (5) weaker liquidity to meet future refinancing requirements. 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.

## **DETAILED RATING CONSIDERATIONS**

The rating assigned to ASG reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for Government-Related Issuers. In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for ASG and then considers the likelihood of support coming from the UK government in the event that ASG faces acute liquidity stress.

### **Baseline Credit Assessment**

ASG's BCA of a2 reflects the following factors:

#### **Institutional Framework**

English housing associations operate in a highly regulated environment, with strong oversight exercised by the sector's regulator, the Homes and Communities Agency (HCA). The HCA's levers of control are extensive and currently range from monitoring the quality of accommodation, to vetting governance and financial viability and arranging short-term property inspections.

Housing associations have limited revenue flexibility, but a majority of their revenue is stable and predictable. An annual increase in social housing rent, which represents the bulk of revenues for most housing associations (81% for ASG), is currently capped at a rate of the retail price index (RPI) + 0.5%. Recent reforms have granted greater rent flexibility by allowing social-housing rents to rise up to 80% of market rent ("affordable rent") for new tenants and re-lets. This reform is credit positive, but is limited in impact given that new tenants and re-lets account for a minor proportion of most housing associations' total income. Housing associations in economically stronger regions, where the difference between social housing and market rent is greater, may benefit more from the reform. The Comprehensive Spending Review 2013 announced that social rents will rise by the consumer price index (CPI) + 1% from 2015/16 for 10 years, which is expected to be credit neutral, as although it provides certainty and stability to housing associations' planning and operations, we expect it to limit rent increases and constrain revenue growth.

A high share of social-housing rental income (54% average for Moody's-rated peers; 53% for ASG) is composed of housing benefit, which has provided a stable and secure revenue stream to housing associations over the year. That being said, the progressive roll-out of universal credit from October 2013 (and full transition by 2017) will see the benefits of working-age tenants paid directly to tenants (rather than to housing associations directly prior to reform), which is a source of credit risk for the sector. We view this risk as manageable for most housing associations given the sector's policy responses. For example, ASG has mitigated the risk by (1) improving its rent-collection rates, with total rent arrears now at 4.5%; and (2) recent initiatives to increase awareness of the reform to tenants and to employees, to improve tenants data, to strengthen collection procedures and staffing, also through external reviews, and to support direct debit payments (currently 43% of non-housing-benefit-related rental income). Housing benefit represents an estimated 28% of ASG's total income, compared to 29% average for Moody's-rated peers.

## Issuer Profile

ASG is a large provider of social housing in England, with around 56,000 units under management at March 2013. Operations are spread nationwide across over 120 local authorities, where demand for social housing is generally high and social-housing rents are on average two-thirds market rates (closer to one-third for London).

## Financial Performance

ASG's revenue grew to £305 million in FY 2013 (2012: £273 million), reflecting rising turnover from social-housing letting (81% of revenues) and growing contribution from sales (13% of revenues compared to 10% in FY 2012). ASG's operating margin widened to 35% of revenues in FY 2013 (2012: 33%), which exceeds the average of its Moody's-rated peers, and is mainly a reflection of tight cost controls for social housing lettings. ASG's total margin (before tax) also strengthened to 20% of revenues in FY 2013 (2012: 17%), reflecting only minor increase in interest expenditure and slight contribution from fixed-asset disposals.

ASG's recurrent cash-interest coverage ratio (RCIC) is strong and has been continuously improving over the last five years, demonstrating an ability of the organisation to strengthen its operating surpluses, while containing its interest costs. Although this was partially enabled by the current low-interest-rate environment, RCIC slightly grew to 2.5x in FY 2013 (2012: 2.4x; average 2009-2013: 2.2x), which exceeds the average of Moody's-rated peers. The social-housing-letting interest-coverage ratio (including depreciation) was stable at 1.9x in FY 2013 (2012: 1.9x; average 2009-2013: 1.8x).

ASG's business plan expects a sharp rise in its total revenue, which is projected to grow to approximately £440 million in FY 2015 (up 45% compared to FY 2013) and stay around this level until FY 2018. The increase is mainly driven by ASG's growing involvement in sales (first-tranche shared-ownership and outright), but is also complemented by a solid growth in social housing lettings, as new units are being delivered. Sales revenue is projected to peak at 32% of revenues in 2015 and average at 24% in 2014-18, which is high compared to its Moody's-rated peers. Although we recognise that rising exposure to sales adds risk and complexity to ASG's operations going forward, we note that following factors significantly mitigate these risks: (1) all development for sale is located in London or south-east of England, where the demand is buoyant and property prices are expected to hold strong; (2) ASG has experience with delivering large-scale development projects (sales worth of around 100 million delivered in the last three FYs); (3) all contracted development is covered by cash or available facilities; (4) around 40% of sales projected for FY2014-18 are aspirational and still to-be-committed, with ASG having the ability to scale them down if market conditions deteriorate; (5) there is no reliance on sales to cover interest cost.

Operating margin is projected to remain one of the highest among Moody's-rated peers, averaging at 36% over 2014-18, which will enable ASG to maintain its recurrent cash-interest coverage at strong levels between 2.1x-

2.4x going forward, despite the rise in interest costs due to recent bond issuance and planned draw-downs on its revolving facilities. The social-housing-letting interest coverage is expected to be relatively stable around 1.8x in FY2014-15 and then slightly decline to 1.5x in FY2016-18, which is still above the average of Moody's rated peers and shows no reliance on higher-risk activities to meet interest payments.

#### Debt profile and liquidity

At FYE 2013, ASG's debt was £1.22 billion, which was equivalent to around 4.0x revenues and 45% of assets at cost, against cash holdings of £87 million. Over the past few years, debt has remained fairly stable and has been used to support the company's relatively modest capex programme, which averaged around 27% of revenues in 2009-2013 and peaked at 44% in 2009. Going forward, debt is anticipated to grow to around 4.6x revenue in FY2014 as a result of a draw-down of £200 million on ASG's revolving facility. As the sales start elevating turnover in FY2015, the debt will decline to 3.7x revenue (around 3.2x, net of cash) in spite of around £250 million of new funding ASG plans to seek in the same year. The new capital will be partially used to repay revolving facilities and to finance ASG's stable development pipeline (social and for-sale).

In its business plan for FY2014-18, ASG has de-risked its development of social housing rental units by (1) distributing its investment activity more evenly among all the years (previously more concentrated in FY 2014-15); and (2) reducing the total number of units to be delivered by FYE2015 by 600 (20%), as the number of units converted to affordable rent was lower than previously envisaged. Net capex is projected to peak at 63% of revenue in 2014 and average 24% over FY2014-18. ASG also plans to execute a disposal of strategic assets located in the prime area of London, which should yield over £120 million that will be used to finance development of new social housing units.

At FYE 2013, 91% of ASG's outstanding debt was due after five years, which included two bullet bonds (both nominal value of £250 million), maturing in 2038 and 2042. Around 16% of debt was held at floating rates, which is within ASG's treasury policy target of floating-rate debt between 15% and 35% of total debt. Its loan portfolio does not include any options. Management makes use of standalone interest-rate swaps for hedging (notional of £292 million). At the end of June 2013, these contracts had a negative marked-to-market value of £82.5 million. The resulting margin call was fully met by property security. Moreover, ample available assets whether charged, but still unallocated (estimated at £308 million at EUV as of 30 June 2013) or unencumbered (£605 million at EUV) ensure further margin calls (in excess of 100bps) can be properly met.

ASG enjoys strong liquidity position, supported by abundance of unencumbered assets. At end of June 2013, an immediately available liquidity was £475 million. It is equivalent to 156% of revenues, which is above the average of Moody's-rated peers and sufficient to cover total cash commitments within the business plan. Unencumbered assets could provide additional liquidity equivalent to approximately 285% of revenue.

#### Governance and management

ASG's management team has a strong track record executing and delivering on the company's plans. Its targets for 2013 were met and were in line with our expectations, reflecting efficiencies realised from review of procurement and maintenance services, lower than planned cost of funding, and stronger sales turnover. ASG's new business plan for 2014-18 is a prudent scenario and is based on (i) LIBOR rates of 1.8% in FY2014 (2.3% in 2015; 3.5% in 2016, rising to 5.8% by 2018); (ii) RPI at 2.6% in FY2014 (2.5% from 2015 onwards); (iii) social rent increase by RPI+0.5% in FYs 2014-15 and by CPI+1% for ten years onwards; (iv) affordable rents capped at 65% from FY2016; (v) nil real growth in general costs; and (vi) house prices inflation of 2.5%. To accommodate for the possible adverse impact of welfare reform the business plan assumes (i) rising bad debts from 1.2% in FY 2014 to 3.5% in FY 2018 and onwards (currently at 0.7%); (ii) rent arrears rising from 6.5% in FY 2014 to 9.5% in FY 2018 (currently at 4.5%). Assumptions underlying the potential bond issuances also allow for considerable headroom for interest costs.

Should operations come under stress, ASG's management notes they would consider (1) cutting non-core spend (around 6 million a year); (2) reducing major works; and (3) suspending an indicative part of development pipeline.

ASG has prepared itself for the decline in capital grants from UK government by (i) strengthening internal controls (i.e., minimum interest coverage of 1.6x, up from 1.4x; minimum level of unallocated unencumbered assets held with security trustee of £150 million (currently £308 million); (ii) focusing on efficiency savings; (iii) avoiding any reliance on sales for interest costs; (iv) limiting debt growth to 5x revenue; and (v) intending to keep sales exposure below 30% of turnover. The only slight deviation is expected in FY 2015 (32%), but only because the development had been contracted before the rule was established.

ASG targets a minimum cash balance of £50 million, with total liquidity required to cover all committed development (both of which are comfortably met). All borrowing facilities are currently secured and immediately available. New commitments are solely entered into once funding is made available.

ASG's debt covenants include debt service and asset coverage. All covenants are fully met and allow for strong headroom within ASG's business plan.

### **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 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 ASG 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 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 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 ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in October 2012 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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