MOODY'S
INVESTORS SERVICE

Credit Opinion: Affinity Sutton Group Ltd

Global Credit Research - 04 Nov 2014

United Kingdom

Ratings

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

Contacts

Analyst	Phone
Benisek, Stanislav/London	44.20.7772.5454
Elizabeth Bergman/London	
David Rubinoff/London	

Key Indicators

Affinity Sutton Group Ltd

	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14
Units under management (no.)	55,157	56,103	56,107	56,467	56,856
Housing assets (GBP million)	2,150	1,316	1,428	1,527	1,674
Operating margin, before interest (%)	31.8	32.6	33.3	35.0	38.2
Net capital expenditure as % turnover	3.8	27.9	37.9	22.4	38.1
Social housing letting interest coverage (x times)	1.8	1.9	1.9	1.9	2.1
Recurrent cash interest coverage (x times)	2.0	2.4	2.4	2.5	2.7
Debt to revenues (x times)	3.6	4.2	4.3	4.0	4.1
Debt to assets at cost (%)	44.6	43.4	45.0	44.5	45.2

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 ASG's rising exposure to sales and relatively high proportion of variable rate debt.

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 A3. ASG's relative position reflects strong and stable margins, high cash flow 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

- Comfortable liquidity position supported by ample unencumbered assets and moderate debt levels

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

- Strong regulatory framework and revenue stability supported by housing benefit

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

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) continuous strengthening of operating margins and social-housing-letting interest coverage ratio; (2) debt structurally falling below 3.5x revenue or 40% of assets at cost; (3) a reduced scale of outright sales activity, which have potential to increase revenue 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 recurrent cash-interest coverage below 1.5x; (4) debt levels structurally above 5x revenue; and (5) weaker liquidity impacting ability 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 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.

VERY HIGH AND STABLE OPERATING MARGINS AND INTEREST COVERAGE RATIOS

ASG's operating margins have averaged 34% over of turnover over the last five years, which was well above the median of its rated peers of 25% over the same period. 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 widened to 38% of revenues in FY2014 from 35% in FY2014, compared with the 2014 average of rated peers of 29%. ASG's total margin (before tax) also strengthened to 23% of revenues in FY 2014 (FY2013: 20%) despite a lower contribution from asset disposals.

ASG's social-housing-letting interest-coverage ratio (including depreciation), measuring an ability of the organisation to cover interest costs from its low-risk activities, strengthened to 2.1x in FY2014 (2013: 1.9x) and remained among the highest within the Moody's rated peers (2014 average: 1.4x). The improvement was driven by a stronger margin on social-housing lettings coupled with stable interest costs. The recurrent cash-interest coverage ratio (RCIC) grew to 2.7x in FY2014 (2013: 2.5x), which exceeds the average of rated peers of 2.1x. We also view positively that both coverage ratios have continually strengthened over the last five years, which demonstrates the improved ability of the organisation to service its debt despite some increase in indebtedness. We note, however, that the improvement was also enabled by the current low interest rate environment as ASG

held around 26% of debt in variable rates, up from 16% in March 2013 and above the 15% average of its rated peers.

Operating margin is projected to remain one of the highest among Moody's-rated peers, averaging at 36% over 2015-19, which will enable ASG to maintain its social-housing-letting interest coverage at strong levels around 2x over the next two years. Although ASG projects some weakening from FY2017 as a result of a new long-term funding planned to be secured in FY2016, the cover is still projected to remain at solid levels of around 1.6x showing no reliance on higher-risk activities to meet interest payments. The recurrent cash interest coverage is projected to grow significantly to levels above 3x as a result of planned increase in turnover and surplus from outright sales.

COMFORTABLE LIQUIDITY POSITION SUPPORTED BY AMPLE UNENCUMBERED ASSETS AND MODERATE DEBT LEVELS

ASG enjoys a strong liquidity position, supported by abundance of unencumbered assets. Immediately available liquidity, represented by cash and readily available undrawn facilities, was GBP391 million at end of June 2014. It is equivalent to 122% of revenues, which is above the current average of Moody's-rated peers (102%) and is sufficient to cover total cash commitments within the business plan. Unencumbered assets, valued at almost GBP1.07 billion at Exiting Use Value for Social Housing (EUV-SH), could provide additional liquidity of around GBP1.01 billion, equivalent to approximately 317% of revenue and well above the current rated peers average of 212%.

ASG's debt reached GBP1.32 billion at FYE2014, which was equivalent to around 4.1x revenues and 45% of assets at cost, against cash holdings of GBP73 million. Relative indebtedness has remained fairly stable over the past four years, with some new funding used to support the company's comparatively moderate and stable capex programme, which averaged around 26% of revenues in 2010-2014 and peaked at 38% in FY2014. Going forward, debt is anticipated to decline to around 3.5x revenue despite ASG's plans to gradually take on around GBP320 million of net new funding over 2015-19. The decline in relative indebtedness is driven by ASG planned expansion into the outright sales market, which will significantly lift its turnover in coming years (see below). The new capital is likely to be composed of around GBP250 in public bonds and about GBP70 million in cumulative draw down from revolving facilities. The new funding will be used to finance ASG's stable development pipeline of social and for-sale units. ASG's net capex is projected to peak at 22% of revenue in FY2015 and average 10% over FY2015-19, which is in line with rated peers.

At FYE 2014, 89% of ASG's outstanding debt was due after five years, which was broadly in line with an average of rated peers. The amortisation schedule is fairly smooth over the next five years, with around 30-35 million falling due every year. ASG's debt portfolio already includes two bullet bonds (both nominal value of GBP250 million), maturing in 2038 and 2042. Exposure to interest-rate risk is relatively high as 26% of debt was held at floating rates. Although higher than peer's average, it is within ASG's treasury policy target of 15% and 35%. Management makes use of standalone interest-rate swaps for hedging (notional of GBP291 million). At the end of June 2014, these contracts had a negative marked-to-market value of GBP76.5 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 57,000 units under management at March 2014. Operations are spread nationwide across almost 100 local authorities, where demand for social housing is generally high and social housing rents are on average three-quarters of market rates (closer to one-third for London).

ASG's management team has a strong track record in driving efficiencies, containing its cost base and delivering on the company's plans. It kept the management costs flat over the last five years at GBP30 million while the gross rental income increased by 23% over the same period. Management targets for 2014 were slightly over performed, reflecting stronger performance of FTSO sales, lower than budgeted operating costs and cost of funding. Although assumptions underpinning ASG's 2015-19 business plan are slightly less prudent compared to previous business plan, they continue providing a layer of contingency and we therefore expect that ASG will meet its financial targets for FY2015. The assumptions include: (i) LIBOR rates of 0.5% in FY2015 (1.8% in 2016, rising to 5.3% by FY2019); (ii) RPI at 3.2% in FY2015; (iii) CPI at 2% from FY2016 onwards; (iv) most affordable rents capped at 65% from FY2016; (v) repairs inflation at 2.7% in FY2015 (up from 2.0% last year); (vi) general cost inflation at 2.5%; and (vii) house prices inflation of 2.5%. To accommodate for the possible adverse impact of

welfare reform the business plan assumes (i) bad debts rising to 2.5% by FY 2019 (currently at 1.3%); (ii) rent arrears rising to 9.0% by FY 2018 (currently at 4.0%). Assumptions underlying the potential bond issuances also allow for material headroom for interest costs compared to current yields.

Management's commitment to the financial strength of the organisation is demonstrated by the formation of financial "golden" rules more than 10 years ago. These rules, which are regularly reviewed and strengthened, include: (i) minimum level of unallocated unencumbered assets held with security trustee of GBP150 million (currently GBP565 million); (ii) avoiding any reliance on sales to meet financial obligations; (iii) limiting debt growth to 5x revenue; and (iv) maintaining debt service ratio above 1.15x; or (v) intending to keep sales exposure below 30% of turnover. There are two slight deviations currently expected FY2016 and FY2019 when the sales are projected to reach 31% and 36%, respectively. However, the deviations relate to ASG's planned regeneration projects, which ASG intentionally excludes from the threshold. 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's management places an importance on liquidity of its funds and therefore targets a minimum cash balance of GBP50 million at all times. Total liquidity (including undrawn facilities) is required to cover all committed development (both comfortably met). All borrowing facilities are currently secured and immediately 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.

STRONG REGULATORY FRAMEWORK AND REVENUE STABILITY SUPPORTED BY HOUSING BENEFIT

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 sector's regulator is responsible for protecting the public investment in social housing (GBP4,541 million at YE2013) as well as the reputation and financial viability of the sector. To this end, economic and consumer standards have been set, which HAs are expected to meet. Compliance with economic standards is proactively monitored by the HCA through quarterly returns, long term business plans 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.

Social housing rents, which represents the bulk of revenues for most housing associations (83% for ASG), are stable and predictable, but their level is set by the central government, which limits associations' revenue flexibility. Over the next 10 years, the annual increase will be limited to the consumer price index (CPI) + 1%.

Over half of social-housing rental income is composed of housing benefit, which has historically provided a stable and secure revenue stream to housing associations. The implementation of Universal Credit threatens the stability of revenues as benefits will be paid directly to working age tenants rather than to housing associations. While roll out of Universal Credit began in October 2013, it has not been implemented on a wide scale basis and timeframe for full implementation remains uncertain. We view this risk as manageable for most housing associations given management's high awareness of the issue and a range of mitigating measures being typically put in place, including proactive management of rent arrears, support for tenants or promotion of direct debit payments. Housing benefit at risk of being affected, that paid to working age tenants, represents an estimated 32% of ASG's total income, compared to 29% average for Moody's-rated peers.

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

ASG's revenue grew to GBP320 million in FY 2014 (2013: GBP305 million), predominantly reflecting rising turnover from social-housing letting (83% of revenues). Turnover from units developed for sale (outright and FTSO) remained broadly stable at GBP38 million, which represents 12% of turnover and was in line with the 2014 average of rated peers. ASG's sales were relatively stable contributing between 10-14% of turnover over the last five years.

However, ASG's business plan outlines a sharp rise in sales income (both outright and FTSO), which is projected to grow to approximately 29% of turnover (GBP89 million) in FY2015, peak at 36% of revenues in FY2019 and average 28% over 2015-19, which is high compared to its rated peers. We note that rising exposure to sales has a potential to add volatility to it turnover and complexity to its operations going forward, however we currently view this position as manageable given that there are some factors that significantly mitigate the aforementioned risks:

(1) all development for sale is located in London or south-east of England, where the demand is demand is currently buoyant; (2) ASG has experience with delivering large-scale development projects (sales worth of over 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 FY2015-19 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 the units, which would consequently result in a deterioration of projected cash flows, this could exert a pressure on ASG's rating. We also note that average margin on outright sales assumed in ASG's business plan is 21% over 2015-19, which is higher than 13% achieved over the last five years. This is however, somehow driven by the fact that some of these schemes are situated in prime areas of London.

ASG's previous business plan outlined an intention to build 800 units for private rent, but these were removed from the latest plan following the conclusion of ASG's feasibility analysis.

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 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%).