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CREDIT OPINION
24 February 2017

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RATINGS

**Great Places Housing Group**

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

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Great Places Housing Group

## Update to Key Credit Factors

## Summary Rating Rationale

The A2 issuer rating assigned to Great Places Housing Group (GPHG) reflects its ample liquidity relative to its net capital requirements, improved operating performance in recent years, and large presence in the north west. The rating also takes into account GPHG's increasing exposure to non-social housing letting activities and potential weakening of interest coverage ratios in the near future.

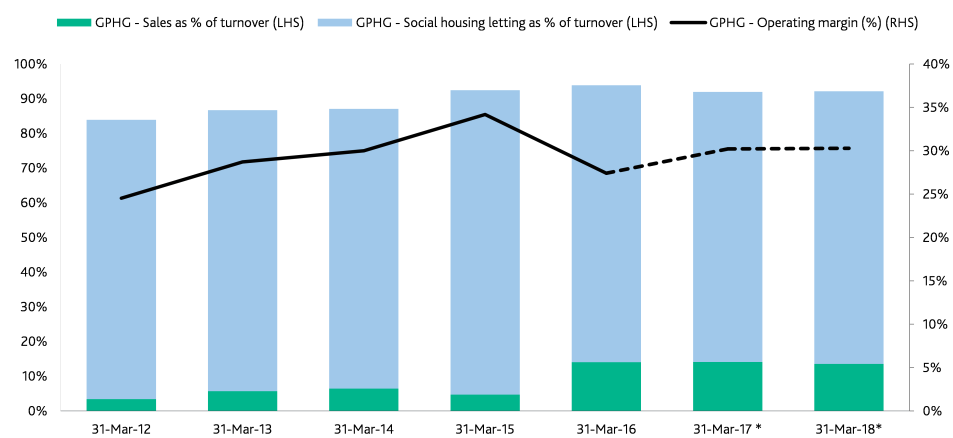
In addition, GPHG's A2 rating benefits from the strong regulatory framework governing English housing associations and our assessment that there is a strong likelihood that the UK government (Aa1 negative) would intervene in the event that GPHG faced acute liquidity stress.

GPHG is rated in the middle of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1.

Exhibit 1

**Great Places' operating margin dropped in FY2016 due to an increase in low margin sales activities.**

**GPHG operating margin (%), Social housing lettings as a (%) of turnover, Sales as a (%) of turnover**




Note: FY2015 and FY2016 have been restated in FRS102 format. *FY2017-FY2018 are forecasts.
*Source: Great Places and Moody's*

## Credit Strengths

Credit strengths for GPHG include:

» Ample liquidity and low interest rate risk

- » Simple group structure with high share of revenues coming from social housing lettings, albeit decreasing
- » Strong regulatory framework

## Credit Challenges

Credit challenges for GPHG include:

- » Rising debt to support development programme
- » Average margins and sufficient interest coverage ratios expected to drop in the short term
- » Government policy changes make operating environment more challenging for housing associations

## Rating Outlook

The negative outlook on GPHG's rating reflects the negative impact of the vote to leave the European Union on housing associations as well as the negative outlook on the sovereign rating, reflecting the close institutional, operational and financial linkages between the central government and housing associations.

## Factors that Could Lead to an Upgrade

Upward rating pressure on HAs is unlikely to develop in view of the challenging operating environment and weakened sovereign credit conditions. Strengthening credit metrics of stand-alone credit profiles, however, could put stabilising pressure on Great Places' rating. A combination of the following could have positive rating implications: (1) reduced exposure to market sale activities; (2) maintaining a healthy operating margin at or above 35%, and (3) social housing letting interest coverage structurally exceeding 1.6x.

## Factors that Could Lead to a Downgrade

Downward ratings pressure on the affected HAs would be prompted by further deterioration of the UK sovereigns' creditworthiness. Additionally, any sector or issuer-specific risks emerging in this context would exacerbate downward ratings pressures. Negative pressure could be exerted on the rating by one or a combination of following: (1) sustained increase in debt to above 5.5x revenues; (2) a material weakening in operating performance, with social-housing-letting interest coverage falling below 1.0x; (3) structural increase in proportion of turnover coming from shared ownership and outright sales.

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.

## Key Indicators

**Great Places Housing Group**

| | 31-Mar-12 | 31-Mar-13 | 31-Mar-14 | 31-Mar-15 | 31-Mar-16 | 31-Mar-17 * | 31-Mar-18* |
|---|---|---|---|---|---|---|---|
| Units under management (no.) | 16,147 | 16,498 | 16,785 | 17,515 | 18,409 | 19,343 | 19,509 |
| Operating margin, before interest (%) | 24.5 | 28.7 | 30.0 | 34.2 | 27.4 | 30.2 | 30.3 |
| Net capital expenditure as % turnover | 72.2 | 39.9 | 45.9 | 45.8 | 41.4 | 32.5 | 14.6 |
| Social housing letting interest coverage (x times) | 1.4 | 1.7 | 1.1 | 1.4 | 1.3 | 1.1 | 1.1 |
| Cash flow volatility interest coverage (x times) | 1.7 | 2.3 | 1.6 | 2.0 | 0.9 | 1.5 | 1.5 |
| Debt to revenues (x times) | 4.6 | 4.7 | 4.8 | 5.2 | 4.8 | 5.0 | 4.9 |
| Debt to assets at cost (%) | 37.0 | 39.0 | 39.6 | 46.2 | 47.2 | 48.8 | 48.5 |

FY2017* and FY2018* are forecasted figures. Note that FY2015 and onwards are prepared in FRS102 format while prior years were prepared using the old UK GAAP.
*Source: Great Places and Moody's*

## Recent Developments

As part of the new financial reporting framework, HAs in the UK were required to report FRS102-compliant accounts from March 2016, including comparatives for March 2015. Categories of the accounts which are most impacted include: housing assets, social housing grant, pensions, and financial instruments. Housing assets may be valued at cost or valuation as under the previous framework, or at deemed cost, which is a revaluation of housing assets at the date of transition. Social housing grant is no longer deducted from the cost of housing assets, but rather recognised as a long-term creditor and amortised. Moody's will continue to adjust gearing to exclude the revaluation reserve, whether an HA values its assets at deemed cost or valuation.

## Detailed Rating Considerations

GPHG's A2 rating combines a baseline credit assessment (BCA) of baa1 and a strong likelihood of extraordinary support coming from the national government in the event that GPHG faced acute liquidity stress.

### Baseline Credit Assessment

#### AMPLE LIQUIDITY AND LOW INTEREST RATE RISK

GPHG's liquidity position is solid compared to its peers, equal to their forecast net cash requirements for the next three years. Great Places' outperforms Moody's rated peers on its liquidity coverage ratio, this metric measures the ability of available liquidity to cover the following two years of net capital expenditure. GPHG's liquidity coverage ratio was 2.2x in September 2016, above the Moody's rated peer median of 1.5x. GPHG's liquidity position is strong, however, the association is hindered by a low level of unencumbered assets, an important measure of funding flexibility as the assets are needed to secure future borrowing. The low grant environment means that GPHG will rely on its expected market sales receipts to fund 32% of its development programme over the next five years. GPHG estimated in September 2016 that its unencumbered assets could support £87 million of new secured debt, equivalent to 84% of turnover and below the latest rated peer average of 207%.

Interest rate risk within GPHG's debt portfolio reduced significantly after the issuance of its 30-year, fixed-rate bond in October 2012. GPHG currently holds just 9% of its debt at floating rates as of March 2016, down sharply from over 30% pre-bond. The latest position is in-line with GPHG's treasury policy which requires a minimum of 75% of total debt at fixed rates. The association hedges a sizeable share of its interest-rate risk using stand alone swaps. These contracts have a notional value of £127 million, and had a negative mark-to-market value of just over £54 million at the end of June 2016. GPHG is obliged to provide collateral in the form of cash or property to derivative counterparties and the resulting margin call of around £30 million was fully met by cash collateral. Cash posting is more flexible than using property as security, however, it adds complexity to cash management, requiring strict monitoring, and limits liquidity, an important consideration for housing associations such as GPHG with a large development programme relative to its size.

#### SIMPLE GROUP STRUCTURE WITH HIGH SHARE OF REVENUES COMING FROM SOCIAL HOUSING LETTINGS, ALBEIT DECREASING

GPHG's group structure is straightforward, with GPHG as the group non-asset holding parent, which, by way of the centralised board and single management team, controls two registered providers: Great Places Housing Association and Plumlife Homes. The group also includes two unregistered subsidiaries, one focusing on outright sales and another on design and build contracts. GPHG is a medium-sized provider of social housing, managing around 18,500 homes as at March 2016. Operations are concentrated in 36 local authorities across the north west of England, with core activities in and around the city of Manchester. GPHG is also one of the leading developers in the north west, and its relative size allows the association to take advantage of economies of scale and enhanced expenditure flexibility. While social rents in the region tend to be closer to market rents than in the south of England, which would theoretically reduce the associations' market power, there remains a high demand for GPHG's properties, one of its key credit strengths.

Social housing letting as a percentage of GPHG's turnover remained in-line with its historical average over the last five years at 80% in FY2016, closely aligned with the median for Moody's A2 rated peers (83% in FY2016). Given that GPHG's updated business plan envisages some expansion into commercial activities, turnover from social housing letting will decrease to 76% by FY2020. This metric will however, likely remain in line with rated peers going forward. GPHG plans to gradually increase its exposure to market sales from "low" to "moderate", with proceeds from first tranche shared ownership and outright sales forecast to account for an average of 15% of turnover (moderate exposure) over the next five years, compared with an average of 5% (low exposure) in the last five years. While we note that GPHG is coming from a relatively low base in terms of sales exposure, we consider the increase to around 15% to be a key credit risk.

### 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 the ability to award capital grant funding, levy financial penalties, and impose independent inquiries or appoint new managers and officers in extreme circumstances. The HCA emphasizes that their role is a co-regulatory one with the primary onus being on boards and executive teams to ensure compliance with the standards. As part of the Housing and Planning Act 2016, the Regulator's powers are expected to weaken in several areas including: removal of the consent to dispose of housing assets, removal of constitutional consents for group restructuring including mergers, and stricter conditions for appointing officers. The dilution of regulatory oversight and power is credit negative, although we expect the Regulator to continue to take an active role in managing risk in the sector.

### RISING DEBT TO SUPPORT DEVELOPMENT PROGRAMME

GPHG aspires to develop around 2,200 units over the next five years. The development pipeline has a projected tenure mix of 45% on affordable housing, 39% shared ownership and 16% on commercial properties (5% market rent, 11% outright sales). Net capex was 41% of turnover in FY2016, a level which is higher than the A2 peer median of 31%. GPHG consistently holds adequate liquidity cover to support future capital spend (see section titled "Ample liquidity and low interest rate risk").

GPHG's debt was £496 million as at FY2016, around 4.8x revenues and 47% of assets at cost, up from 3.8x and 34% in FY2010. The business plan anticipates that debt will grow to £548 million in FY2020, the new total will be equivalent to 4.7x forecast FY2019 revenues or 48% of assets at cost. While Great Places' debt is increasing, the association's debt metrics are forecast to remain stable, with gearing continuing to be in-line with A2 peers (FY2015 A2 debt-to-assets median: 49%). This is however contingent on the successful implementation of the group's development programme, in which reserves are forecast to grow proportionally with total debt.

Refinancing risk is limited, with 92% of outstanding debt coming due after five years as at FY2016. In its latest treasury strategy, GPHG outline its intentions to negotiate an extension to the maturity of £60 million revolving facility set to expire in November 2018. However, based on current business plans, funding needs will be met by other undrawn facilities over the next four years, and hence if successfully renegotiated, the £60 million RCF will continue to serve as a liquidity cushion.

### AVERAGE MARGINS AND SUFFICIENT INTEREST COVERAGE RATIOS EXPECTED TO DROP IN THE SHORT TERM.

GPHG's operating margin contracted from record highs of 34% last year to 27% in FY2016. This was due to GPHG's operating costs increasing by about £17 million between FY2015 and FY2016, driven by increased cost of sales (£8.2 million) and higher management costs (£8.4 million). Included within the higher management costs was a one-off FR102-triggered £3.2 million pension remeasurement booked as an operating cost. Despite this decline in operating margin, GPHG is still in-line with the FY2015 A2 peer median of 27%. Previous improvements had been due to the delivery of efficiency savings - a cost-control policy adopted in 2010 resulted in a structural rationalisation of management and procurement costs, and improved rent collection rates. GPHG's current rent arrears declined to 3.3% in FY2016 from 5.3% in FY2011.

We expect the operating margin to recover to around 30% this fiscal year, however GPHG does not project returning to operating margins of 34% or higher, in part due to the increasing proportion of relatively lower margin sales activity (see exhibit 1). The FY2017-21 business plan forecasts first tranche sales achieving an average margin of 9% and outright sales achieving a 13% margin. Operating surpluses will be further impacted by the rent reduction, whereby social rents have been cut by 1% for the next four years. The importance of maintaining profitability over the next few years will be a key credit driver for Great Places Housing Group. GPHG's management highlight the operating margin as one of their four golden rules, aiming to maintain a minimum level of 28%.

GPHG's interest coverage ratios have been sufficient over the past few years, remaining adequate for its position relative to rated peers. The social housing letting interest coverage (SHLIC), a measure of the organisation's ability to cover interest costs from low-risk activities, was 1.3x in FY2016 and remained in-line with the A2 rated peer median of 1.2x; having fluctuated between 1.1x and 1.7x over the last five years. GPHG's latest business plan foresees this ratio decreasing to an average of 1.1x between FY2017-21, as social housing letting turnover will struggle to keep pace with the rising interest costs associated with taking on more debt.

A significant reduction of CFO in FY2016 resulted in a fall of GPHG's cash flow volatility interest coverage (CVIC) from 2.0x in FY2015 to 0.9x in FY2016. The CVIC ratio accounts for movements in cash associated with market sales, and in the case of GPHG, the investment phase of growth has led to a weakening in the ratio as cash is tied up in stock for sale. From GPHG's buisness plans, we expect the CVIC to remain close to the Moody's rated peer median of 1.5x (in FY2015) contingent on the future realisation of sales receipts.

### GOVERNMENT POLICY CHANGES MAKE OPERATING ENVIRONMENT MORE CHALLENGING FOR HOUSING ASSOCIATIONS

The operating environment for social housing providers is fundamentally shaped by government policy and announcements made in July 2015 as part of the UK Summer Budget 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 four years (previously growing 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 extension of Right to Buy for HA tenants. Overall, these policy shifts are gradually eroding the ties to the government by creating a more unpredictable operating environment and undermining the extent and stability of housing benefits contribution to revenues. We do note, however, that the 2016 Autumn Statement announced policies which are more supportive of HA development programmes, notably the availability of additional grants (£ 1.4 billion) and the relaxed tenure restrictions in the affordable homes grant programme, which will now include funding for rented social housing in addition to homeownership tenures.

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represent around 24% of GPHG's total income, below the average 29% of total income for Moody's rated peers. The agreed extension of the Right to Buy to housing associations tenants may in short term lead to positive cash inflows, but creates a risk of a longer term erosion of social housing stock if HAs are unable to replace sold properties.

### 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.

## Rating Methodology and Scorecard Factors

European Social Housing Providers, July 2016 (190944)

Government Related Issuers, October 2014 (173845)

## Ratings

| Category | Moody's Rating |
|---|---|
| **GREAT PLACES HOUSING GROUP** | |
| Outlook | Negative |
| Issuer Rating -Dom Curr | A2 |
| Senior Secured -Dom Curr | A2 |

*Source: Moody's Investors Service*

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