

Global Credit Research - 26 Mar 2013

United Kingdom

## Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Issuer Rating -Dom Curr	*A1
<b>GenFinance II Plc</b>	
Outlook	Rating(s) Under Review
Senior Secured -Dom Curr	*A1

\* Placed under review for possible downgrade on February 25, 2013

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## Key Indicators

### Genesis Housing Association

	31-Mar-08	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Units under management (no.)	37,800	39,714	41,993	40,288	32,955
Housing assets (GBP million)	1,092	1,359	1,372	1,351	1,449
Operating margin, before interest (%)	11.8	10.7	14.4	7.9	18.7
Net capital expenditure as % turnover	171.2	102.2	34.1	9.7	43.8
Social housing letting interest coverage (x times)	0.8	0.5	0.6	0.7	0.7
Recurrent cash interest coverage (x times)	0.8	0.5	1.0	0.9	1.1
Debt to revenues (x times)	4.9	5.5	4.9	4.9	5.6
Debt to assets at cost (%)	51.5	54.7	52.3	50.0	50.1

## Opinion

### SUMMARY RATING RATIONALE

The A1 issuer rating assigned to Genesis Housing Association (GEN) reflects (1) the strong regulatory framework governing English housing associations; (2) the high proportion of revenue GEN derives from government subsidies (housing benefit), which enhances the company's revenue stability; (3) the adequate and improving cash flows GEN generates from a robust foundation of low-risk social-housing letting; (4) improved governance and budget planning; and (5) our assessment that there is a high likelihood that the UK government (Aa1, stable) would act in the event that GEN faces acute liquidity stress. The rating also takes into account (6) GEN's exposure to sales; (7) manageable exposure to universal credit from welfare reform; and (8) high debt-to-revenue ratio, which has historically supported operations and modest capex.

On 25 February 2013, Moody's maintained the final rating of Genesis Housing Association at A1, following a reassessment of the potential provision of extraordinary support and. The BCA was upgraded to baa2 from baa3 to reflect (1) improving cash flows, with plans to eliminate its historical reliance on sales to cover interest costs; (2) reduced risk from hedging; (3) improved liquidity; and (4) stronger controls and budget planning. The rating was also placed on review for possible downgrade as Moody's continues to refine its view on the likelihood of

extraordinary support.

GEN is rated in the mid range of Moody's-rated English housing associations, whose ratings span from Aa3 to A2 (with one exception, rated at Baa2). GEN's relative position reflects weaker margins and cash flows, higher sales and higher debt levels.

### **Credit Strengths**

Credit strengths for GEN include:

- Strong regulatory framework
- Subsidies from the UK government support stability of cash flows
- Satisfactory and improving financial performance after a few years of weaker results
- Management's commitment to tight risk control and a prudent investment programme
- One of the largest housing associations in the UK, with a geographical concentration in London
- Our assessment, which is currently under review, of a high likelihood of extraordinary support from the UK government

### **Credit Challenges**

Credit challenges for GEN include:

- Exposure to sales and temporary housing
- Manageable risks from universal credit
- Relatively high debt levels
- Limited revenue flexibility, which is typical for the sector

### **Rating Outlook**

Since February 2013, Genesis Housing Association's ratings have been on review for downgrade. The review will focus on: (1) our assessment of the likelihood of extraordinary liquidity support in stressed circumstances; and (2) an anticipated discussion document providing an update to the regulatory framework.

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

Whilst unlikely in the near term given GEN's current debt levels, one of the following could have positive rating implications: (i) operating margin improving to levels above 30% revenues; (ii) a social-housing-letting interest coverage structurally exceeding 1.5x; (iii) debt falling below 4.5x revenue; (iv) a scaling-back in its development-for-sales programme, whilst successfully delivering projected sales in 2013-17; and (v) an upgrade of the UK sovereign rating.

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

Negative pressure could be exerted on the rating by (i) an increase in sales in excess of current plans or weaker sales profits; (ii) a deterioration in its recurrent cash-interest coverage below 1.0x; (iii) a renewed reliance on sales to cover its interest costs; and (iv) debt levels that remain above 6x revenue. 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**

On 22 February 2013, Moody's downgraded by one notch the government of the United Kingdom to Aa1 stable from Aaa negative. Following the sovereign downgrade, we downgraded the ratings of 26 English Housing Associations by one notch, due to a reassessment of the potential provision of extraordinary support from the regulator, and ultimately the government, should an HA experience acute liquidity stress.

### **DETAILED RATING CONSIDERATIONS**

The rating assigned to GEN 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 GEN and then considers the likelihood of support coming from the UK government to avoid an imminent default by GEN, should this extreme event ever occur.

### **Baseline Credit Assessment**

GEN's BCA of baa2, 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, or HCA (formerly the Tenant Services Authority). 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.

Revenue flexibility is limited, but "affordable rent" provides some leeway in the long term. An annual increase in social housing rent, which represents the bulk of revenues for most housing associations, is capped at a rate of the retail price index (RPI) + 0.5%. Recent reforms have granted greater rent flexibility to English housing associations, allowing social housing rent to rise up to 80% of market rent ("affordable rent") for new tenants and re-lets. In the short to medium term, we expect the impact of the rent reform to be limited.

Government subsidies support revenue stability; universal credit is a manageable risk. A high share of social-housing rental income (around 74% for GEN, which is above the average of its Moody's-rated peers) is composed of housing benefit attributable to tenants, most of which is transferred directly from local governments to housing associations. Under the universal credit welfare reform, benefits (including housing benefit) to working-age tenants will be paid directly to tenants. As a result, housing associations will lose the advantage of direct payment - a credit strength in the sector - for a share of their income (estimated at around 33% for GEN, which is in line with the average of its Moody's-rated peers). However, we note that this is a manageable risk for GEN given (i) its improving, albeit still higher than peers, rent-collection rates, with current rent arrears now at 6.0%, gross of housing benefits; and (ii) its recent initiatives to increase awareness of the reform among tenants, to improve tenants data, to strengthen collection procedures and staffing in order to harmonise performance across the group and improve current underperformance on leaseholders collection, and to support direct debit (currently 25% of general needs rental income).

#### **Issuer Profile**

GEN's homes under management fell to around 33,000 at March 2012, down from around 40,000 the previous year primarily due to the cessation of Local Authority Management Contracts. GEN operates across London and the south-east of England in 86 local authority areas, where demand for social housing is generally high and social housing rents are on average less than 40% of market rates. GEN is the market leader in temporary housing for homeless persons, being active in this field for over 20 years (around 3,500 homes).

#### **Financial Performance**

GEN's revenue fell to £260 million in FY 2012 (2011: £275 million), reflecting lower fees from management services and, to a lesser extent, declining temporary housing social housing letting (23% of revenues). Social housing letting (80%, including temporary housing) and sales (18%) were stable year-on-year. GEN's operating margin widened to 19% of revenues in FY 2012 (2011: 8%; average 2008-2012: 13%), which is below the average of its Moody's-rated peers. This improvement largely reflected tight cost controls for social-housing letting general needs, temporary housing and other activities, which more than offset lower profits on first-tranche shared ownership sales and losses on outright sales (largely related to one underperforming scheme in London). GEN's total margin (before tax) also improved to 10% of revenues in FY 2012 (2011: 1%; average 2008-12: 4%), reflecting strong profit on fixed-asset disposals of 8% of revenues in FY 2012 (2011: 10%; average 2008-12: 8%).

GEN's recurrent cash-interest coverage ratio widened to 1.1x in FY 2012 (2011: 0.9x; average 2008-12: 0.9x; peak/trough 2008-12: 1.0x/0.5x), which is below the average of Moody's-rated peers. The social-housing-letting interest-coverage ratio (including depreciation) was stable at 0.7x in FY 2012 (2011: 0.7x; average 2008-12: 0.7x; peak/trough 2008-11: 0.8x/0.5x).

GEN expects that a steady rise in social-housing letting and one-off contributions from sales will continue to drive

its revenue going forward. Sales revenue (from first-tranche shared-ownership and outright sales) is projected to peak at 26% of revenues in 2014 and average 15% in 2013-17, which is relatively high compared to its peers. Cash flow is projected to improve gradually so as to eliminate GEN's historical reliance on higher risks activities or sales to cover interest costs. The social-housing-letting interest coverage is projected to widen to around 1.2x and the recurrent cash-interest coverage at around 1.4x.

#### Debt and Liquidity

At FYE 2012, GEN's debt was £1.44 billion, which was equivalent to around 5.6x revenues and 50% of assets at cost. Over the past few years, debt has risen to support the company's operating deficits and capex programme, the latter of which averaged around 71% of revenues in 2008-12 and peaked at 171% in 2008. Going forward, debt is anticipated to fall to around 4.5x-5x revenue over 2013-17, reflecting larger sales revenue and a modest development pipeline (social and for-sale); net capex is projected to average 15% and peak at 34% of revenue in 2013, against planned proceeds from asset disposals averaging 12%. The latter is related to still-to-be-committed asset disposals of void general needs units.

At FYE 2012, 94% of GEN's outstanding debt was due after five years. GEN's amortisation profile is fairly smooth, with the earliest peak repayment over £100 million in 2032 and in 2040; the latter reflecting its bullet bond issued in FY 2010.

At December 2012, 6% of GEN's debt was held at floating rates. Immediately available liquidity was £181 million, which is equivalent to 70% of revenues and is sufficient to cover total cash commitments within the business plan.

#### Governance and Management

GEN's new senior management shows strong capacity in executing plans. Internal controls and budget planning have improved to meet its renewed corporate objectives: (1) a simplified governance structure (now fully delivered, following amalgamation of GEN's existing four registered providers into "Genesis Housing Association"); (2) a leaner and stronger executive team (now complete, following new executive directors in "Organisational Effectiveness" and "Communities"); (3) a leaner second-tier management (currently work-in-progress); and (4) further streamlining of its corporate functions (i.e., procurement, service delivery; currently work-in-progress).

Its targets for 2012 were met and were in line with our expectations. GEN's latest business plan for 2013-17 is a balanced central case based on (i) LIBOR rates of 1% in 2013 (2% in 2014; 2.25% in 2015, rising to 4.5% by 2017); (ii) RPI at 5.6% in 2013 (3.5% from 2014-15; 3% from 2016 onwards); (iii) 0.5% real growth in general costs; (iv) flat voids and bad debts; and (v) nil inflation in house prices.

GEN is focused on internal consolidation to strengthen its core rental income via efficiency savings and eliminate its historical reliance on sales to cover interest costs. Development has scaled down, but still accounts for rising sales as a cross subsidy, given lower capital grants from the UK government and the new 'affordable rent' programme.

GEN has a conservative liquidity strategy, and its hedging strategy allows for margin-call risks. Its loan portfolio is fully restructured to reduce interest and refinancing risks.

#### Extraordinary Support Considerations

The high 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 an enforced merger or a transfer of engagements. Recent history has shown that the UK government is willing to support the sector and it has, in the past, provided a guarantee for a housing association's overdraft facility. Moreover, housing remains a politically sensitive issue, contributing to the high potential for support. However, recent developments highlight the practical difficulties in providing extraordinary support, and Moody's is currently reassessing the levels of extraordinary support to the housing association sector. Moody's also assigns a very high default dependence between GEN and the UK government, reflecting their strong financial and operational linkages.

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##### 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,

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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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