MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
10 January 2017

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RATINGS

Genesis Housing Association

Domicile	United Kingdom
Long Term Rating	Baa1
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.

Contacts

Amir Girgis 44-20-7772-5310
Analyst
amir.girgis@moodys.com

Jennifer A. Wong 4420-7772-5333
VP-Senior Analyst
jennifera.wong@moodys.com

David Rubinoff 44-20-7772-1398
MD-Sub Sovereigns
david.rubinoff@moodys.com

Genesis Housing Association

Update to Key Credit Drivers

Summary Rating Rationale

On 20 December 2016, the issuer and debt ratings assigned to Genesis Housing Association (GEN) were affirmed at Baa1, following the submission of a new standalone business plan after the subsequently cancelled merger plan with Thames Valley Housing Association (TVHA). The merger was called off on 23 August 2016, citing cultural and operational differences, GEN has subsequently submitted a new standalone business plan. As a standalone entity, we still expect GEN to operate with weak interest cover ratios as it continues to deliver a commercially focused development pipeline.

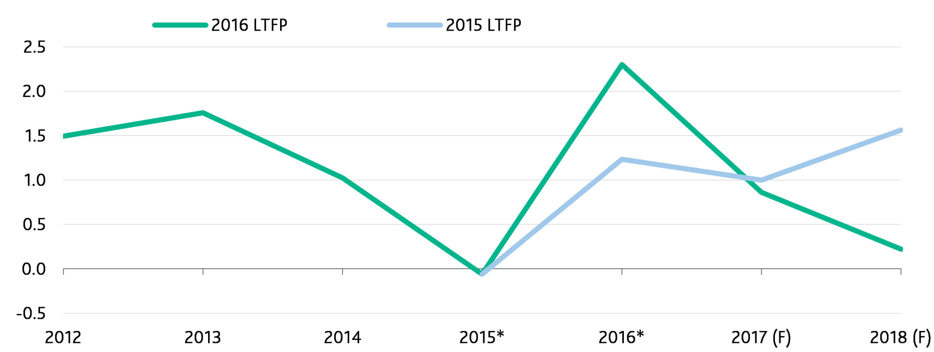
The Baa1 ratings reflect: (1) large housing association operating in high demand areas; and (2) moderate liquidity and access to an investment fund (LINQ). The rating also takes into account: (1) weak interest cover ratios; (2) Weak margins; and (3) continued focus on growth agenda.

In addition, ratings in the sector benefit 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 GEN faces acute liquidity stress. The entity is rated at the bottom of the Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. GEN's relative position reflects GEN's high capital expenditure, its exposure to non-social housing activity, structurally low social housing interest cover and uncertainty with respect to future growth.

Exhibit 1

Genesis's cash interest cover is volatile and weak compared to previous forecasts, with the cover expected to fall below 1.0x in FY2017 and FY2018

Cash interest cover by long term financial plan (LTFP), 2012 - 2018



Note: FY2015 and FY2016 have been restated in FRS102 format. FY2016-FY2021 are forecasts.
Source: Genesis, Moody's

Credit Strengths

» Large housing association operating in high demand areas

» Moderate liquidity supported by investment arm vehicle

» Strong regulatory framework

Credit Challenges

» Sustained low and volatile cash interest cover

» Increasing reliance on non-social housing revenue structurally weakens social housing interest cover

» High capital expenditure

» Management expected to continue growth agenda following termination of merger

Rating Outlook

The negative outlook on GEN's ratings reflect 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

Moody's believes that upward ratings pressure on the HAs affected by the UK Sub-Sovereign Brexit action is unlikely to develop in view of the challenging operating environment and weakened sovereign credit conditions.

However, a combination of the following could have positive rating implications:

» A social-housing-letting interest coverage structurally exceeding 1.2x;

» A reduction in market sales activity with a corresponding moderation in capital expenditure

» A reduction in volatility in cash flow from operations

Factors that Could Lead to a Downgrade

» A sustained reliance on sales and/or other high-risk activities to cover interest costs while social housing letting interest coverage ratio structurally remains below 0.8x

» Planned sales not performing according to budget leading to a deterioration of GEN's already low operating margins

Key Indicators

Exhibit 2

Genesis Housing Association

	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.)	32,955	32,925	32,369	31,510	31,066	31,132	31,100
Operating margin, before interest (%)	18.7	20.4	24.4	24.0	19.2	27.6	22.9
Net capital expenditure as % turnover	43.8	16.0	44.8	62.7	3.9	61.3	121.7
Social housing letting interest coverage (x times)	0.7	1.0	0.9	1.0	0.8	1.1	1.0
Cash flow volatility interest cover (x times)	0.9	1.0	0.8	-0.8	1.1	-0.3	-0.7
Debt to revenues (x times)	5.6	4.8	5.3	5.3	4.5	5.2	5.8
Debt to assets at cost (%)	50.1	47.3	46.8	53.9	52.3	51.6	55.4

*FY2017 and FY2018 are forecasted figures. Note that FY2015 and onwards are prepared in FRS102 format while those before were prepared as per the old UK GAAP.

Recent Developments

On 23 August 2016, GEN announced that its merger with Thames Valley Housing Association (TVHA) has been canceled citing "differences in style and approach". The core driver behind the merger was to create added capacity by forming a combined entity with 47,000 units under management and deliver an aspirational development pipeline of 3,000 units per year. GEN has previously stated its desire to move away from a grant subsidy model and towards a market subsidy model. In response to reduced grant availability, GEN have consciously opted to limit its reliance on new grant funding, as such annual grants relative to turnover have dropped from 27% in FY2011 to 1% in FY2016. Although this downward trend is similar for other organisations, GEN remains resolute to grow its business by filling the gap with debt and proceeds from its riskier and more volatile commercial activity. While the merger might have failed, we believe that the organisation still remains committed in moving away from a grant subsidy model via increased long term market sale exposure.

On 23 June 2016, the UK voted to leave the European Union in a referendum and on 24 June 2016, a negative outlook was placed on the UK's Aa1 sovereign rating. We expect protracted trade negotiations, resulting in a high level of uncertainty in the medium term which will manifest in slower economic growth. On 29 June 2016, the outlook of GEN's Baa1 rating was changed to negative from stable reflecting that the vote to leave the EU is negative for housing associations (HA), whose creditworthiness is linked to the sovereign, driven by three main factors: 1) reduction in the predictability of policy-making as the sovereign could squeeze HAs budgets through additional cuts in housing benefit, grants, or other policy channels, 2) volatility in the housing market, which would impact, in particular, those HAs like GEN with expected greater exposure to open-market sales, and 3) the loss of EU funding for capital spending and potentially higher cost of borrowing when raising debt on the capital market.

As part of the new financial reporting framework, HAs in the UK are 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 a HA values its assets at deemed cost or valuation. GEN has decided to revalue its housing properties at deemed cost. With social housing grants are no longer deducted from housing assets, this has resulted in a significant increase in the balance sheet valuation of its assets. This treatment affects GEN's gearing, which increases under Moody's calculation method, though we look through these accounting changes.

Detailed Rating Considerations

GEN's Baa1 rating combines (1) a baseline credit assessment (BCA) of ba1 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

LARGE HOUSING ASSOCIATION OPERATING IN HIGH DEMAND AREAS

GEN are a large social landlord with a housing stock under management that stands at approximately 32,000. GEN operates across London and the South East England in approximately 83 local authorities. GEN have additionally adopted a strategic asset management approach over the years enabling them to divest of stock over the years and invest in new homes. In addition GEN has addressed its land bank issue which it has faced following the economic downturn that resulted from the financial crises of 2008. The demand for social housing is generally high and social housing rents are on average at 33% of market rates. This gap between social and market rent is credit positive as it supports high demand for social housing stock as well as revenue uplift should the organisation increase its exposure towards affordable housing and market rent.

MODERATE LIQUIDITY SUPPORTED BY INVESTMENT ARM VEHICLE

GEN has a liquidity cushion of GBP 374.5 million in immediately available liquidity, of which GBP 96 million is cash and GBP 278.6 million is available through secured, undrawn facilities. This level of liquidity is able to cover 70% of GEN's future two-year net capital requirements of GBP 536.1 million. This indicates a reliance on further funding to realise its committed and uncommitted development programme. We note that the organisation tightly reviews all covenants and its current business plan is not expected to breach any existing gearing covenants. In addition, a stress test of 30 percent reduction in house prices will only lead to a covenant breach in FY2022. We note that GEN also complies with its internal liquidity policy of only engaging and committing to development schemes once funding is secured. Moody's will continue monitoring this policy as any breach could exert downward pressure.

GEN also has access to a property owning vehicle (LINQ), which can counteract its moderate liquidity cover ratio. The investment vehicle enables suitable units to be sold at a 50 year market rent investment value. Genesis has sold 72 units into LINQ in FY2016, and the option of immediately selling a large portion of units to LINQ is perceived as credit positive as it provides GEN's with immediate access to cash. Our view is that access to LINQ de-risks GEN's reliance on market sales.

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 including 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 its 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 still expect the Regulator to take an active role in managing risk in the sector.

SUSTAINED LOW CASH INTEREST COVER

GEN's cash interest cover is volatile and weak, with the cover expected to remain below 1.0x for three consecutive years in both the new standalone business plan and under the merger plan. GEN's cash interest cover is weak relative to peers. Weak cash flow from operations (CFO) is a direct consequence of GEN's development pipeline and movements in work in progress relating to its shared ownership and outright development. For an entity expected to deliver GBP 385 million in turnover in FY2017, GEN expects to realise only GBP 7 million in cash flow from operations (before interest) in FY2017. This is a consequence of reduced sales receipts (GBP47 million in FY2017 compared to GBP 170 million in FY2016) combined with heavy investments in outright sales and shared ownership stock. Until the cash receipts are realised in later years, CFO remains drastically low and is unable to cover yearly net cash interest payments in the next three years (FY2017-2019). GEN will consequently rely on debt and reserves to cover net cash interest due.

Cash interest cover is expected to average 0.6x over the next three years, substantially below the Moody's portfolio median of 2.2x. This highlights the sustained low levels of cash flow generation and the cyclicality of its cash flows from operations, putting considerable downward pressure on GEN's credit rating. Moody's acknowledges that a majority of its pipeline is uncommitted and cash interest cover would improve substantially if the uncommitted pipeline is not initiated.

INCREASING RELIANCE ON NON-SOCIAL HOUSING REVENUE STRUCTURALLY WEAKENS SOCIAL HOUSING INTEREST COVER

On a standalone basis, GEN's social housing lettings revenue averaged 81% relative to total turnover for the past five years (FY2012-2016), and will average 72% over the next 5 years (FY2017-2021). This increased focus on non-social housing letting is a direct response to the 1% social housing rent reduction and will add to the structural inability of the association to cover interest from social housing surplus. GEN's interest coverage from social housing rents in FY2016 was 0.8x, dropping from 1.0X in FY2015. The drop was primarily driven by a loss in its temporary housing of GBP 8.8 million in FY2016 mainly due to a one-off maintenance expenditure relating to health and safety compliance. This cover is expected to remain structurally below 1.0x over the next five years, and below the Moody's-rated portfolio median of 1.4x. A social housing lettings interest cover of less than 1.0x is credit negative as it signals a reliance on surpluses from non-social revenues to meet interest payments.

HIGH CAPITAL EXPENDITURE RESULTING IN NEW FUNDING REQUIREMENT

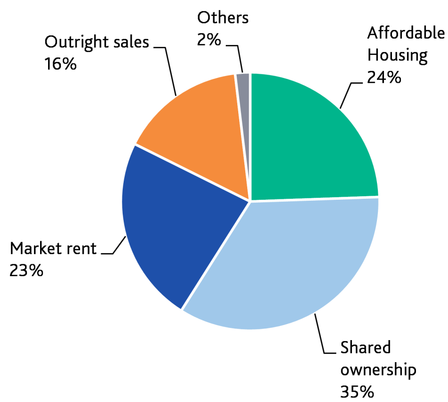
Under GEN's standalone development plans, net capital expenditure is expected to peak at 122% of revenues in FY2018, far above GEN's standalone past five-year average of 35%. This raised capital expenditure level is expected to remain high between FY2017-2019, averaging 87%, well above the 18% median of Moody's rated portfolio. Again, Moody's acknowledges that a large proportion of this development is uncommitted and GEN will only commit once funding is in place. The flexibility to scale down its development is positive, but management is not signalling any desire to scale back. As a result, GEN is expected to deliver its development pipeline and operate with low social housing letting and cash interest coverage ratios. GEN's aspirations are expected to be funded through a mixture of its own reserves, anticipated cash flows, and new additional borrowings. Growth in total debt is driven by uncommitted development and is expected to increase from GBP 1.5 billion in 2016 to GBP 2.0 billion in 2021 and we consequently expect gearing to increase to 56% in FY2021 from 52% in FY2016.

MANAGEMENT EXPECTED TO CONTINUE GROWTH AGENDA FOLLOWING TERMINATION OF MERGER

GEN's merger with Thames Valley was driven by the boards' desire to substantially increase its long-term development pipeline. While the merger might have been called off and while GEN will certainly not be subject to the same short term development risks, Moody's expects GEN to maintain a long term growth focus and remain “merger ready” as it aims to fulfil its ambition to develop more units by playing an active role in addressing the London housing supply shortage. Whilst GEN is set on growing their balance sheet and developing more houses, they monitor internally set board approved golden rules - should they breach any of these, it is expected that they will withdraw a proportion of uncommitted expenditure.

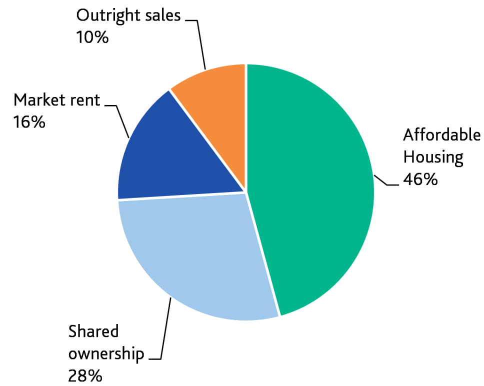
GEN's merger aspirations were deemed aggressive and illustrates the organisations willingness to grow. The merged entity was to develop approximately 16,000 new units over the first 5 years, a sizeable increase from GEN's standalone development plan. Despite the merger being cancelled, GEN as a standalone organisation still maintains a notable development pipeline of 3,940 units over the next 5 years; this development pipeline represents a development pipeline of 13% relative to its current size. While we note that GEN have reduced its 5 year development risk from its previous pre-merger 2015 standalone business plan (4830 units), the tenure mix has become more commercially oriented (Exhibit 3 and 4).

Exhibit 3
Genesis's 2016 LTFP is primarily focused on open market activities
Genesis's LTFP, as per March 2016



Source: Genesis, Moody's

Exhibit 4
Last year's (2015) LTFP had more of a focus on social housing
Genesis's LTFP, as per September 2015



Source: Genesis, Moody's

We expect less than 25% of completed units to be intended for social purposes, with the remainder being allocated to either sales, shared ownership, or market rent. Shared ownership and outright sales will make up the largest portion (58%) of new developments over the next 5 years. We note that GEN has generated sales margins averaging 11% over the past three years. Nonetheless, GEN is ambitiously expected to generate on average 28% on sales in the first five years (FY2017-2021). While we acknowledge that certain regeneration programmes will contribute to margin uplift, our view is that potential volatility in the UK housing market following the UK vote to leave the EU could make realising these margins challenging. Moody's also positively notes that the model conservatively assumes that 50% of the Market sale Product units from the uncommitted development programme are retained as Market Rent for two years after completion before realising the sale.

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 (RtB) 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 (GBP 1.4 billion) and the relaxed tenure restrictions in the affordable homes 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 on 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 (Aa1 negative) 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 its operations and make an extraordinary intervention more challenging.

In addition, our assessment that there is very high default dependence between GEN and the UK government reflects their strong financial and operational linkages.

Rating Methodology

European Social Housing Providers, July 2016 (190944)

Government Related Issuers, October 2014 (173845)

Ratings

Exhibit 5

Category	Moody's Rating
GENESIS HOUSING ASSOCIATION	
Outlook	Negative
Issuer Rating -Dom Curr	Baa1
GENFINANCE II PLC	
Outlook	Negative
Senior Secured -Dom Curr	Baa1

Source: Moody's Investors Service

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Contacts

Amir Girgis 44-20-7772-5310
Analyst
amir.girgis@moodys.com

Olivier Li-Wei Heinen +44 20 7772 1429
Associate Analyst
olivier.heinen@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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