

Credit Opinion: Genesis Housing Association

Global Credit Research - 30 Sep 2015

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	A2
GenFinance II Plc	
Outlook	Stable
Senior Secured -Dom Curr	A2

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Key Indicators

Genesis Housing Association

	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
Units under management (no.)	40,288	32,955	32,925	32,369	31,510
Housing assets (GBP million)	1,351	1,449	1,418	1,540	1,605
Operating margin, before interest (%)	7.9	18.7	20.4	24.4	24.7
Net capital expenditure as % turnover	9.7	43.8	16.0	44.8	59.6
Social housing letting interest coverage (x times)	0.7	0.7	1.0	0.9	1.0
Recurrent cash interest coverage (x times)	0.9	1.1	1.4	1.2	1.2
Debt to revenues (x times)	4.9	5.6	4.8	5.3	5.4
Debt to assets at cost (%)	50.0	50.1	47.2	46.8	48.3

Opinion

SUMMARY RATING RATIONALE

The A2 issuer rating assigned to Genesis Housing Association (GEN) reflects (1) margins anticipated to remain stable despite policy changes; (2) operating in high demand areas; (3) improved management and the successful implementation of their transformation programme. The rating also takes into account (1) Increasing reliance on non-social housing revenue; (2) structural weakening in social housing interest cover and; (3) thin liquidity mitigated by internal controls.

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 stable) would intervene in the event that GEN faces acute liquidity stress.

GEN is rated in the mid range of Moody's-rated English housing associations, whose ratings span from Aa3 to A3. GEN 's relative position reflects strategic operational focus, stable operating margins and increasing exposure to non-social housing activity, structurally low social housing interest cover and a thin liquidity position.

Credit Strengths:

Credit strengths for Genesis (GEN) include:

- Large housing association operating in high demand areas
- Margins expected to remain stable despite policy change
- Improved management and governance
- Strong regulatory framework

Credit Challenges:

Credit challenges for Genesis include:

- Increasing reliance on non-social housing revenue structurally weakens social housing interest cover
- Thin liquidity position mitigated by internal liquidity controls
- Government policy changes make operating environment more challenging for housing associations

Rating Outlook

The outlook on GEN's rating is stable, reflecting GEN's position within its rating category and our view that the organisation has the capacity to maintain its financial performance and debt profile close to current levels despite the financial pressures imposed on the housing association sector by the policies announced in the UK Summer Budget 2015. Our view is supported by GEN's recent track record of delivering efficiencies and realising savings as well as their desire to maintain development aspirations albeit with a different tenure mix as they attempt to increase their independence by moving away from grant funding.

What Could Change The Rating - Up

One or a combination of the following could have positive rating implications: (1) operating margin improving to levels above 30% revenues; (2) a social-housing-letting interest coverage structurally exceeding 1.5x; (3) a material reduction of GEN's debt burden via the scaling back of commercial activity.

What Could Change The Rating - Down

Negative pressure could be exerted on the rating by one or a combination of following: (1) a continued reliance on sales and/or other high-risk activities to cover its interest costs with social housing letting interest coverage ratio sustained below 1x; (2) weakening debt metrics; (3) unforeseen delays in development delivery leading to lower-than-projected margins and/or low interest covers. 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 8 July 2015 the UK government announced a number of measures that we view as credit negative for the sector, notably a 1% annual reduction in social housing rents over the next four years. The rent reduction coupled with additional benefit reforms create a more difficult operating environment for English housing associations. Please see the section entitled "Government policy changes make operating environment more challenging for housing associations" for details.

Genesis's projected financial metrics referenced in this report factor the impact of the measures on its strategy and financial performance. GEN have considered a range of options that can be implemented to address the forecasted revenue reduction and have opted to maintain their development aspirations and refocus their tenure mix allowing for increased focus on commercial activity. The revised business plan incorporating the impact is expected to be approved by the board in October 2015. Management response to the challenging operating environment has been immediate and consistent forming a crucial part of their overall impact assessment.

DETAILED RATING CONSIDERATIONS

GEN's A2 rating combines (1) a baseline credit assessment (BCA) of baa2 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 31,510 as at 31 March 2015. Genesis Housing Association operates across London and the South East England in 86 local authorities, where 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 their exposure towards affordable housing and market rent.

MARGINS EXPECTED TO REMAIN STABLE DESPITE THE POLICY CHANGE

Successful implementation of "The Genesis Way" has helped GEN realise operating margins of 25% in FY 2015. GEN expect operating margins to remain at similar levels moving forward despite the rent reduction policy as management continues to implement realistic efficiency gains and as they downsize operations in low margin activities driven by a more stringent appraisal process. GEN will continue with their aspirations of developing 5000 new units, an increase in total size of 15%, over the next 5 years. GEN have instead re-assessed their optimal tenure mix, eliminating the provision of social rent for all new units and instead focusing on the delivery of more profitable Affordable Housing, Shared ownership and outright sales. This increased commercial exposure leads to increased reliance on the housing market remaining buoyant in order for GEN to deliver their business plan. GEN have additionally estimated that right to buy will contribute 250 replacement units each year from 2017 and beyond, an amount that we deem realistic.

Genesis have doubled their operating social housing surplus to GBP 68.6 million in 2015 from GBP 34.3 million in 2010. This surplus is particularly supported by strong delivery in their general needs business with margins of 47%. Despite this strong performance in general needs, GEN's operating margin relative to peers remains below the median of the A2 category (30%) and this is largely driven by low margins from temporary housing and care business which combined represent a third of GEN's turnover.

IMPROVED MANAGEMENT AND GOVERNANCE

The successful implementation of The Genesis Way transformation programme helped GEN deliver GBP 20 million on annual savings, and this highlighted management's ability to deliver calculated planned cost reductions. In response to the policy change, Genesis plans to target further efficiency savings by cutting operating costs by GBP 5 million over the next three years, a decrease of 2.4% on their 2015 operating costs of GBP 212.3 million. Moody's believes that this target reduction is attainable due to the size of the reduction. We acknowledge however that any further significant efficiency savings would be harder to implement given that the business has already reduced 8.5% of its operating cost base between FYE2013 and FYE2014 at the back of its transformation programme. Management is not relying on any additional efficiency savings additional to the GBP 5 million in order to deliver their business plan.

In addition, GEN is pursuing a proactive asset management plan, in which it aims to rationalise their stock as they consolidate their operations reviewing the split between Supported, Shared ownership, Intermediate and market rent provision.

Extensive stress tests of their revised long-term business plans have been performed in accordance to minimising the risk of covenant breach in the short and medium term. Scenarios include LIBOR, CPI, and RPI fluctuations, bad debt increases, falling sales prices, sales delays, and combinations of these scenarios show sufficient covenant headroom. Gearing covenants are recorded at 65% although Genesis has an internal target of 55%. Only a few unlikely scenarios, including LIBOR increasing by 5% and sales prices of properties falling by 30% have resulted in breaches in legal gearing covenants. All financial and non-financial covenants are compliant as at 30 June 2015 and are forecast to remain compliant under their base case moving forward.

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 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. 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. We expect that the rapidly changing environment will put increased pressure on the regulator.

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

The proportion of revenues from low-risk activities have averaged 81% for the past five years (2011-2015) but are projected to decrease and average 74% over the next five years. This increased focus on non-social housing letting is a direct response to the latest policy changes and will add to the structural inability of the association to cover interest from social housing income. GEN's interest coverage from social housing rents in 2015 was 1.0x, below its rating category peers (peer median 1.2x in 2014) and will hover between 0.9x and 1.0x over the next 5 years. This is true despite the aforementioned strengthening in profitability in their social housing lettings business.

GEN's history of volatility in their non-social housing lettings revenue highlights the cyclicity of their cash flow from operations. Cash interest cover was recorded at 0.6x in FY2015 and has experienced fluctuations over the last five years (Peak - 2013:1.8x; Trough - 2011:0.4x). GEN forecasts show cash interest cover settling at a 1.3x average over the next 5 years - albeit thin at 1.0x at FY2017 due to an accelerated development plan. This volatility combined with their weak social housing interest cover represents a credit challenge for GEN.

In the context of a reduced grant environment, GEN have consciously opted to limit their reliance on new grant funding, as such annual grants relative to turnover have dropped from 27% in 2011 to 3% in 2015. The association has filled the gap with proceeds from their riskier and more volatile commercial activity. Despite this drop in annual grant funding over recent years, the organisation carries GBP 1,215 million of historical grants on their balance sheet (41% of housing assets at cost) in FY2015. This high level of historical grant on balance sheet restricts their ability to deregister as a registered social housing provider despite their deliberate move away from grant funding.

THIN LIQUIDITY POSITION MITIGATED BY INTERNAL LIQUIDITY CONTROLS

Immediately available liquidity as of June 2015 is comprised of undrawn secured revolvers of GBP 50 million as well as GBP 64.2 million of cash. Combined, this capital is equivalent to 41% relative to turnover, considerably less than the 99.7% median of its A2 peers and the 91% median of the Moody's HA portfolio. This is credit negative particularly as GEN are increasing their reliance on non-social housing activity. However, GEN have added GBP 56 million in approved facilities from the HCA and are adding an additional GBP 125 million in revolving credit facilities, which combined with existing liquidity, would total GBP 295 million or 104% relative to turnover, a level that is more in line with peers if they were not to use these new revolvers to fund new developments.

The new anticipated liquidity level (GBP 295 million) would enable GEN to fund 73% of their two-year net-capital requirements (GBP 404 million), indicating a reliance on further funding to realise their aspirational development programme. Net financing requirements in FY2016 and FY2017 are expected to reach GBP 176.3 million. As of June 2015, the entity held a large portfolio of unencumbered properties valued at GBP 458 million on an EUV-SH basis, which provides security to support the required future borrowing needs. Moody's views this thin liquidity cover as manageable given GEN's compliance with internal liquidity policy of only engaging and committing to development programmes once the funding is secured. Moody's will continue monitoring this policy as any breach could deplete their liquidity reserves.

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 recent budget announcements have made these circumstances more challenging. On July 8th, 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 growth 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, which we view as credit positive, by creating a more unpredictable operating environment and undermining the extent and stability of housing benefit's contribution to revenues.

Moody's preliminary assessment indicates that the change in the rent formula will result in an average annual

sector loss in total turnover of 7% for our rated portfolio over the four years starting FY2017. It is also likely to cause a decline in a currently high proportion of housing associations' turnover coming from social housing rents (81% in FY2014).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents GBP102 million, an estimated 36% of GEN's total income, compared to 29% average for Moody's-rated peers. GEN put in place a range of mitigating measures to respond to Welfare Reform, including proactive management of rent arrears, support for tenants or promotion of direct debit payments. The extension of the Right to Buy to housing association tenants may in short-term lead to positive cash inflows, but creates a risk of a longer term erosion of social housing stock if this stock is not replaced on a 1:1 ratio. We will continue to monitor the impact of the proposed Right to Buy extension on GEN's asset base and revenues. The association has added in its business plan 250 units to be built as 1:1 replacements for Right to Buy (RtB).

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 GEN and the UK government reflects their strong financial and operational linkages.

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National and Global Scale Ratings

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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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