

Credit Opinion: Genesis Housing Association

Global Credit Research - 03 Oct 2014

United Kingdom

Ratings

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

Contacts

Analyst	Phone
Roshana Arasaratnam/London	44.20.7772.5454
Jeanne Harrison/London	
David Rubinoff/London	

Key Indicators

Genesis Housing Association

	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14
Units under management (no.)	41,993	40,288	32,955	32,925	32,369
Housing assets (GBP million)	1,372	1,351	1,449	1,418	1,540
Operating margin, before interest (%)	14.4	7.9	18.7	20.4	24.4
Net capital expenditure as % turnover	34.1	9.7	43.8	16.0	44.8
Social housing letting interest coverage (x times)	0.6	0.7	0.7	1.0	0.9
Recurrent cash interest coverage (x times)	1.0	0.9	1.1	1.4	1.2
Debt to revenues (x times)	4.9	4.9	5.6	4.8	5.3
Debt to assets at cost (%)	52.3	50.0	50.1	47.2	46.7

Opinion

SUMMARY RATING RATIONALE

The A2 issuer rating assigned to Genesis Housing Association (GEN) reflects (1) solid financial performance, in particular, increasing margins and coverage figures; (2) strong geography in the South East (especially London); (3) commitment towards a financial strategy programme to improve efficiencies. The rating also takes into account (1) high debt to revenue which, historically has been used to support operations and modest capex and; (2) some volatility in revenue due to outright sales and market rents.

In addition, ratings in the sector benefit from (1) the strong regulatory framework governing English housing associations; (2) the revenue stability provided by government subsidies (housing benefit), although this may come under pressure from the introduction of universal credit; and (3) 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 at the mid range of Moody's-rated English housing associations, whose ratings span from Aa3 to A3. GEN 's relative position reflects high debt levels, strategic operational focus, improving operating margins, outright sales levels and increasing market rent exposure.

Credit Strengths

Credit strengths for GEN include:

- solid financial performance resulting in stronger margins and interest coverage going forward
- increasing levels of unencumbered assets, providing ample headroom against MTM exposure
- commitment by management team to delivering ongoing transformation
- strong likelihood of extraordinary support from the UK government

Credit Challenges

Credit challenges for GEN include:

- future business plan has ongoing exposure to fluctuating and diversified revenue streams
- relatively high debt levels to revenues

Rating Outlook

The outlook on GEN rating is stable.

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 debt levels.

What Could Change the Rating - Down

Negative pressure could be exerted on the rating by one or a combination of following (1) deterioration in its recurrent cash-interest coverage below 1.0x; (2) weakening debt levels; and/or (3) a reliance on sales and/or other high-risk activities to cover its interest costs. 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

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

SOLID FINANCIAL PERFORMANCE RESULTING IN STRONG MARGINS AND INTEREST COVERAGE GOING FORWARD

GEN is a large social landlord with a housing stock under management that stands at 32,369 at 31st March 2014. Genesis Housing Association operates across London and the South East England in 82 local authority areas, where demand for social housing is generally high and social housing rents are well below the market rates. GEN has a large temporary housing stock with around 3,400 units operating in 14 local authorities.

Genesis's financial performance continues to be exposed to some volatility. Revenues decreased from GBP293.4 million in FY 2013 to GBP264.9 million in FY 2014, reflecting lower contribution from sales (FY 2014:8%; FY 2013: 22%) in addition, general-needs turnover reduced (FY 2014: GBP105.6 million; 2013: GBP111.4 million) due to stock rationalisation. Operating margin as a percentage of revenues improved from 20% in FY 2013 to 24% in FY 2014 (average 2010-2014:17%), which is below the average of its Moody's-rated peers. This was sustained by healthy margins in social general needs lettings (2014: 24%; 2013; 23%) and underpinned by controlled costs. Total margin (before tax) remained stable at 15% of revenues in 2014 (2013: 15%; average 2010-14: 10%). GEN's recurrent cash-interest coverage ratio deteriorated from 1.4x in FY 2013 to 1.2x in FY 2014 (average 2010-14: 1.1x), which is below the average of Moody's-rated peers. The social-housing-letting interest-coverage ratio (including depreciation) also decreased from 1.0x in FY 2013 to 0.9x in FY 2014(average 2010-14: 0.8x; trough 2010-14: 0.6x).

INCREASING LEVELS OF UNENCUMBERED ASSETS, GIVING AMPLE HEADROOM AGAINST MTM

EXPOSURE

At June 2014, 11% of GEN's debt was held at floating rates. As of FYE 2014 immediately available liquidity stood at GBP75.4 million, which is equivalent to 28% of revenues. In addition Genesis HA holds a mix of standalone swaps and embedded fixed rate loans that require collateralisation. The gross mark to market value of the standalone interest rate swaps in June 2014 was negative GBP85.1 million, based on the notional amount of GBP350 million of paying fixed rate swaps. This negative exposure is currently collateralised with a combination of cash and charged properties. As of June 2014 there was ample headroom of GBP166 million of potential liquidity that GEN could access if it was to use its existing pre-charged facilities. Genesis is examining opportunities to release properties where this ample headroom allows, and seeks to maintain 10% at either trust or lender level, to ensure sufficient security cover is accessible at all time.

As of FYE 2014 18,430 units with a security value of GBP2.48 billion were charged. The valuation was based on a mix of existing use value for social housing and market value subject to tenancies basis. This adds to 1,018 units with a value of GBP117 million now prepared for charge. Over the next two years 3,832 units are expected to be charged for a potential GBP346 million of additional liquidity. This includes 1,503 units with a value of GBP 193 million currently in the development pipeline.

In addition there is ample headroom against covenant compliance on both interest coverage and gearing covenants.

COMMITMENT BY MANAGEMENT TEAM TO DELIVERING ONGOING TRANSFORMATION

GEN's senior management board remains committed to the implementation of its corporate strategic plan. GEN's strategic objective aims to deliver a leaner and more simplified corporate structure, a reduction in gearing while also increasing margins. The Genesis Way transformation plan was implemented as a vehicle to execute these objectives. Once fully implemented, the project should deliver GBP20 million on annual savings. The impact of these efficiencies has already been implemented into the business plan.

GEN's new business plan for 2015-19 is a balanced central case based on (i) LIBOR rates of 1.3% in 2015 (1.3% in 2016; 2.2% in 2017, rising to 2.9% by 2019); (ii) RPI at 3.2% in 2015 and 2.0% per annum thereafter; (iii) lower funding cost as a result of refinanced debt; (iv) proactive asset management programme.

In addition GEN is pursuing a proactive asset management plan, in which it seeks to rationalise the footprint, and also review the split between Supported, Shared ownership, Intermediate and market rent provision. Revenue related to disposal of fixed assets is planned to be around GBP30 million per annum from void disposals.

Genesis Housing Association Limited (Genesis) is a registered provider and parent of a group. GEN's organisation structure, includes 16 fully owned subsidiaries, incorporating 2 special purpose vehicles for treasury management, 2 charitable organisations and a number of 100% owned subsidiaries for property development and investment. Having amalgamated all its registered providers into "Genesis Housing Association" (GHA), GEN now aims for further simplification of its corporate structure by shutting down one of its SPV's and reappportioning functions with the aim of closing Pathmeads Property Services Limited (GEN's internal maintenance service company). Operational oversight and parental control should improve as a result of a simpler group structure.

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 (£4,541 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 (91% for GEN), 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 high management's 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 21% of GEN's total income, compared to 44% average for Moody's-rated peers in 2013.

FUTURE BUSINESS PLAN HAS ONGOING EXPOSURE TO FLUCTUATING AND DIVERSIFIED REVENUE STREAM

While GEN's business plan anticipates further improvement in its financial performance for the next couple of years, it also expects both social-housing letting to grow steadily and outright sales to peak at 39% of revenues in 2018. This is based on committed schemes plus an aspirational balance to develop at 1000 units pa. While GEN is still defining the composition of the split by tenure, it expects market rent to grow further until 2016 by about 4% when it will become 6% of revenues. It also expects greater exposure to both market rent and outright sales, which combined, is relatively high compared to its rated peers and will increase revenue volatility.

GEN also has a substantial temporary housing portfolio (23% of total revenues in FY 2014) and Supporting People (15% of total revenues in FY 2014).

RELATIVELY HIGH LEVEL OF DEBT TO REVENUES

At FYE 2014, GEN's debt was at GBP1.41 billion slightly below GBP1.42 in 2013, which was equivalent to around 5.3x (FYE 2013: 4.8x) revenues or 47% of assets at cost. Over the past few years, debt has risen to support the Genesis's operating deficits and capex programme, the latter of which averaged around 51% of revenues in 2010-14 (net capex to revenue averaged 31% between 2010-2014) and peaked at 45% in 2014. Next year, debt is expected to decline to 4.4x and then steadily rise to 6.0x by 2017, reflecting a debt increase to support its ongoing capital investment; net capex is projected to average 53% and peak at 103% of revenue in 2017, against planned proceeds from asset disposals averaging 21% over a 2015-2019 horizon. At FYE 2014, 91% of GEN's outstanding debt was due after five years. GEN's amortisation profile is fairly smooth, with the earliest peak repayment over GBP80 million in 2035 and the next one in 2040; the latter reflecting its bullet bond issued in FY 2010.

In addition GEN is participating in some new lending arrangements and has plans for future debt issuance. In particular a loan of GBP46 million has been approved to fund private rental dwelling under the Build to Rent fund. This loan provides funding for up to 50% of the costs of building 485 units on specific sites. Whilst GEN's funding requirements will increase over the medium term to accommodate its new commitments to developments, this financial year the group is might contemplate new funding opportunities.

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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