MOODY'S
INVESTORS SERVICE

Credit Opinion: Poplar HARCA

Global Credit Research - 12 Jul 2013

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	A3
Poplar HARCA Capital Plc	
Outlook	Stable
Senior Secured -Dom Curr	A3

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Key Indicators

Poplar HARCA

	31-Mar-08	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Units under management (no.)	8,359	8,377	8,640	8,461	8,707
Housing assets (GBP million)	106	118	132	154	194
Operating margin, before interest (%)	18.3	14.9	14.4	18.9	12.4
Net capital expenditure as % turnover	63.2	49.0	42.5	42.5	134.9
Social housing letting interest coverage (x times)	1.4	1.3	1.8	1.7	1.3
Recurrent cash interest coverage (x times)	1.6	1.3	1.7	1.8	2.1
Debt to revenues (x times)	3.4	3.6	3.7	3.9	4.9
Debt to assets at cost (%)	55.5	56.4	55.3	53.8	55.9

Opinion

SUMMARY RATING RATIONALE

The A3 issuer rating assigned to Poplar Housing and Regeneration Community Association Ltd (PHL) reflects (1) the strong regulatory framework governing English housing associations; (2) the high proportion of revenues PHL derives from government subsidies (housing benefit), which adds to the company's revenue stability; (3) PHL's presence in the London Borough of Tower Hamlets, an area of strong housing demand; (4) our assessment of a strong likelihood that the UK government (Aa1, stable) would act in the event that PHL faces acute liquidity stress.

The rating also takes into account (5) additional risk from a joint venture for development and an associated sale and leaseback arrangement; (6) above-the-average exposure to changes from welfare reform; (6) a rising debt-to-revenue ratio driven by bond issuance and finance lease arising from sale and leaseback; (7) higher interest costs and breakage costs due to refinancing which lead to projected losses and weak interest cover ratios.

Moody's has also assigned an A3 rating to the proposed £140 million Secured Bonds issued by Poplar HARCA Capital PLC, the financing vehicle of Poplar Housing and Regeneration Community Association Ltd. Given that PHL is ultimately responsible for repayment of the debt, the rating is based on PHL's issuer rating and our review of the draft bond documents.

PHL is rated at the lower end of the range of English housing associations, whose ratings span from Aa3 to A3 (with one exception rated at Baa3). PHL's relative position reflects weaker cash flows, higher debt-to-revenue ratio, weaker margins and lower liquidity, but also favourable geographic location of PHL operations.

Credit Strengths

Credit strengths for PHL include:

- Strong regulatory framework

- Subsidies from the UK government support stability of cash flows

- Geographic location in London where housing demand is buoyant

Credit Challenges

Credit challenges for PHL include:

- Weak projected financial performance, including low interest covers

- Rising debt levels

- Additional risks from a joint venture undertaking development and an associated sale and leaseback scheme

Rating Outlook

The outlook on the rating is stable.

What Could Change the Rating - Up

Whilst unlikely in the near term, a combination of the following could have a positive rating implication: (1) stronger operating performance and more robust interest coverage, particularly from low-risk social housing letting, along with significantly reduced debt levels; (2) strong track record in exceeding current projections - particularly with regard to delivery on its joint venture related developments.

What Could Change the Rating - Down

Negative pressure on the rating could develop from one or a combination of following: (1) inability to deliver projected improvement in operating performance; (2) higher-than-projected debt levels; (3) recurrent cash interest coverage structurally falling below 1x; (4) weaker than projected performance of the joint venture (5) cash-flow instability resulting from the introduction of universal credit. Additionally, any weakening of the regulatory framework and/or any dilution of the overall level of support from the UK government would also exert downward pressure on the rating.

DETAILED RATING CONSIDERATIONS

The rating assigned to PHL 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 PHL and then considers the likelihood of support coming from the UK government in the event that PHL experience acute liquidity stress.

Baseline Credit Assessment

PHL's BCA of baa3 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.

Currently, the 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%. However, 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, as new tenants and re-lets, to whom the new rent regime will apply, account for a minor proportion of most housing associations' total income. The recent Comprehensive Spending Review has proposed that social rents will rise by the consumer price index (CPI) plus 1%; and this is currently out for consultation.

A high share of PHL's social-housing rental income (around 64% for PHL, 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. Following the introduction of universal credit, 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 46% for PHL, which is well above the average of its Moody's-rated peers). To mitigate this, PHL have implemented initiatives to help empower residents to manage their funds and to make sure that any arrears are identified and tackled promptly.

Issuer Profile

PHL is a former Large Scale Voluntary Transfer (LSVT) managing around 8,700 homes as at November 2012. Between 1998 and 2009 Tower Hamlets transferred parts of the Lansbury estate and six other Council housing estates within Poplar to PHL, which was set up for the purpose of regenerating this area of long-standing social and economic deprivation in the East End of London. PHL is a registered housing association with charitable status, spanning 10 estates, and works with one local authority only, Tower Hamlets Council. It owns a third of the land within its area of operations.

PHL has two active subsidiary companies. Poplar HARCA (Developments) Ltd. - trading company, owns a near-complete development at William Cotton Court and also contains a 50% joint venture with Willmott Dixon, Aberfeldy New Village LLP. Leaside Regeneration Ltd. is a company with charitable objects limited by guarantee which came under Poplar HARCA control in January 2012. In addition PHL is also involved in a sale and leaseback arrangement to undertake one phase of the development of Aberfeldy New Village, representing 158 homes. The development plans to build both affordable and market rent homes in a phased scheme.

Financial Performance

PHL has had satisfactory financial performance over the last five years. However, PHL's business plan introduces new risks to its financial health; primarily increased debt and some housing development. These risks and the ability of PHL to achieve satisfactory progress toward projections have been factored into our rating.

PHL's operating margin fell to 12% in FY2012 (2011: 19%), which is relatively low for the sector. The decline was partly driven by increased depreciation charges due to adoption of component accounting and higher refurbishment administration costs. Operating margins will approximate this level in FY2013 and 2014. However, PHL expects that a steady rise in social-housing letting and one-off contributions from sales will continue to drive its revenue going forward. As such, and coupled with some expected expenditure cuts as post-LSVT transfer capital works are completed, PHL's operating margin is projected to rise to 29% in 2017. Additionally, the projected increase in operating margins factors in higher income from market rents on new developments and surplus on developments undertaken by the joint venture.

Rising interest costs from a planned bond and lease payments (associated with the sale and leaseback deal) are anticipated to fully erode PHL's existing bottom-line margin over the next three years (2014: -12%, 2015: -6%; and 2016: -5%). The negative total margin, which reflects the inability of operations to cover costs including debt service, and instead the reliance on reserves to support debt and operations, marks PHL as an outlier among Moody's rated peers. However, PHL's business plan shows the total margin recovering after these years of deficit. The recovery is partially dependent on development revenues, which highlights both the potential benefits and the financial risks the development program adds to PHL. Recurrent cash-interest coverage ratio, which was at 2.1.x in 2012 (2011: 1.8x; average 2008-2012: 1.7x; peak/trough 2008-12: 1.3x/2.1x) is projected to decline to 1.1x in FY2015, reflecting the increase in interest costs following the bond issuance. Its social-housing-letting interest-coverage ratio, (including depreciation) which was 1.3x in 2012, is expected to hover below 1x over FY2014-16 and slightly recover in FY2017.

Net capex was very high in FY2012 (135% of turnover), a function of the extensive refurbishment programme, and is anticipated to stay above 70% until FY2015. While spending is projecting to decrease thereafter, PHL's capex ratios are high as compared to Moody's peers.

Debt and Liquidity

The £140 million bond issue is PHL's first foray into public debt issuance. The bond will refinance £133 million of outstanding bank loans and remove the restrictive loan requirements associated with early stage LSVTs, restrictions being lifted include bank approval of the business plan and limitations on additional borrowing. Proceeds will also pay £6.6 million of breakage costs resulting from the prepayment of the loans and the unwinding of associated embedded swaps. Following the long term financing of PHL's £113 million of variable rate debt and £20 million of variable rate bank debt which has been fixed using embedded swaps, £97 million of bank debt will remain drawn. Moving forward, the revolving credit facility, which had been syndicated, will be divided among Santander and Lloyds, with total access to £145 million, each of which is nearly fully secured with charged properties and following the revaluation of stock, to be completed in three months time, each will be fully secured. Included in the capital restructuring, each of the revolving facilities has been agreed for five years.

While the bonds will be issued by Poplar HARCA Capital plc, the Loan Agreement between the Poplar HARCA Capital plc and Poplar HARCA, the asset holding parent, provides that PHL is ultimately responsible for repayment of the debt. The bonds are secured with a fixed charge on social housing assets. The asset cover test, which requires 1.05x coverage on an EUV basis and 1.15x on an MVT basis, is relatively standard compared to Moody's rated peers. The bond benefits from an interest cover covenant, which is set at just 0.95x and three year coverage averaging 1.05x. Although it is a weak test, it is consistent with similarly rated housing associations. Failure to meet the interest cover test is not an event of default, but may result in a bond holder put option. The bonds will mature in 5 equal payments in 2033, 2035, 2037, 2039 and 2041 followed by a slightly larger final payment in 2043.

Following the refinancing, PHL will have £252 million of debt outstanding at FYE2014. This is equivalent to around 5.8x revenues and 60% of assets at cost. Going forward, debt is anticipated to grow to around 6.2x revenues in 2015 (net of cash) and 65% of assets, which includes the impact of the sale and leaseback deal. A clear shift from PHL's position at year end 2012 of debt equal to 4.9x revenues. The debt issuance will significantly shift the debt to fixed rate with 16% floating at FYE2014. As the business plan calls for additional draws on the variable rate revolvers, this ratio should change over time and become more in line with PHL's target of 50-80% fixed rate.

At the end of July 2013, immediately available liquidity is forecast to be £41 million, which is equivalent to 88% of revenues and is sufficient to cover PHL's planned cash commitments until June 2014. This level is narrow compared to rated peers, who average 162% of revenues. PHL's stock of unencumbered assets, which could be leveraged for additional debt, of £52 million (on an EUV basis) or 106% of revenues, is low compared to rated peers, who average around 190% of revenues. The business plan shows very tight year end liquidity. However PHL management reports that this number will be augmented by draws on the revolving credit facility and they expect to maintain at least £1 million of cash for operations.

Governance and Management Factors

PHL has an experienced management team that is focussing on regeneration opportunities in the Tower Hamlets area and maintaining its core social housing letting business. PHL's overall budget has been delivered as planned for 2013. PHL's forward business plan assumes (1) a LIBOR rate of 1.5% to 3.5% in FY 2013-17; (2) RPI at 2.5 % from 2014/15 onwards; (3) voids and bad debts at 3.3% with arrears forecast to rise by 1% of current rents in response to possible impact of Welfare Reform. Sales proceeds are included, but if not realized, then Poplar has the option to change the tenure of properties to market or intermediate rent. The plan assumes no Right to Buy or Right to Acquire sales (from July 2013 onwards), reflecting conservatism in the plan given that PHL has already realized 10 Right to Buy sales in the three months of this financial year. Further discretionary expenditure is available through deferred maintenance expenditure, given the extensive refurbishment programme recently completed, and regeneration and community development spend which gives some additional flexibility.

PHL has increased exposure to sales and development risk including the joint venture development. In addition, the sale and leaseback arrangement associated with one Aberfeldy Estate development brings additional risks. These are mitigated through indexation being capped at 4.5% and the ability to terminate after each phase of the project. There is still an implementation risk, and possible pressures if it does not make the projected contribution to PHL's overall business plan.

PHL maintains a formal Treasury Management Policy, last updated in 2011. Included is a requirement of an annual report to the Board, the Board has waived this requirement in the last year given formation of a subgroup to oversee the issuance of the bonds. Formal reporting to the Board have been quarterly over the interceding period. Management report that there will be a comprehensive update to the policy and a submission of an annual treasury plan to the Board following issuance of the bond. The treasury policy includes no absolute levels of liquidity requirements for the organization, rather indicates adequate but not excessive levels. Management targets cash on hand of approximately £1 million and points to revolving facilities to provide additional short term liquidity, however PHL consistently maintains more cash on hand. All hedging is done through embedded swaps.

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 politically and economically sensitive issue. However, there are increasing risks, most notably higher exposure to non-core social housing activities, that add complexity to HAs operations and make an extraordinary intervention more challenging. Our assessment was also informed by Cosmopolitan Housing Group's merger that highlighted these practical difficulties in providing extraordinary support.

Moody's also assigns a very high default dependence between PHL and the UK government, reflecting their strong financial and operational linkages.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

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, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in October 2012 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

The Moody's Global Scale rating for issuers and issues in local currency 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%).