

Global Credit Research - 05 Dec 2014

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-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14
Units under management (no.)	8,640	8,461	8,707	8,830	9,059
Housing assets (GBP million)	132	154	194	215	226
Operating margin, before interest (%)	14.4	18.9	12.4	6.8	17.6
Net capital expenditure as % turnover	42.5	42.5	134.9	61.4	62.9
Social housing letting interest coverage (x times) [1]	1.8	1.7	1.3	0.9	0.6
Recurrent cash interest coverage (x times) [1]	1.7	1.8	2.1	1.8	1.0
Debt to revenues (x times)	3.7	3.9	4.9	4.8	5.1
Debt to assets at cost (%)	55.3	53.8	55.9	57.0	59.0

[1] Excluding one-off breakage costs, the social housing letting interest coverage would have reached 0.9x and the recurrent cash interest coverage 1.6x in FY2014.

Opinion

SUMMARY RATING RATIONALE

The A3 issuer rating assigned to Poplar Housing and Regeneration Community Association Ltd (PHL) reflects (1) its high proportion of revenues derived from low-risk social housing lettings, which enhances the entity's revenue stability and (2) a presence in the London Borough of Tower Hamlets, an area of strong housing demand. The rating also takes into account PHL's (1) exposure to development and sales, executed through a joint venture and partially financed by an RPI-linked leaseback arrangement; (2) high and rising indebtedness driven by its historically extensive investment programme; and (3) low margins and weak interest coverage ratios.

The A3 rating also benefits 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 PHL faced acute liquidity stress.

PHL is rated at the lower end of the range of English housing associations, whose ratings span from Aa3 to A3. PHL's relative position reflects weaker interest coverage ratios, lower operating margins and higher indebtedness, but also favourable geographic location of PHL operations.

Credit Strengths

Credit strengths for PHL include:

- High proportion of turnover composed of social housing lettings, which supports cash flow stability
- Favourable geographic location
- Strong regulatory framework and revenue stability supported by housing benefit

Credit Challenges

Credit challenges for PHL include:

- Weak financial performance, highlighted by low operating margins and thin interest cover ratios
- High and rising debt levels, which limit potential for accessing additional liquidity, if needed
- Additional complexity and sales risk from a sizeable development project carried through a joint venture and partially funded by an RPI-linked lease 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 positive rating implications: (1) stronger operating performance and more robust interest coverage ratios, particularly from low-risk social housing letting; (2) significantly reduced debt levels; and (3) a strong track record in exceeding current projections and delivering on its development projects, especially those undertaken by its joint venture.

What Could Change the Rating - Down

Negative pressure on the rating could develop from one or a combination of the following: (1) an inability to deliver a projected improvement in operating margins that would strengthen its ability to service debt; (2) higher-than-projected debt levels, resulting in depletion of unencumbered assets; (3) gradual weakening of interest coverage ratios; and (4) structural erosion of its currently adequate liquidity position. 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

PHL's rating combines (1) its baseline credit assessment (BCA) of baa3, and (2) a strong likelihood of extraordinary support coming from the UK government in the event that PLH faced acute liquidity stress.

Baseline Credit Assessment

HIGH PROPORTION OF TURNOVER COMPOSED OF SOCIAL HOUSING LETTINGS, WHICH SUPPORTS CASH FLOW STABILITY

PHL's total turnover has grown steadily over the last five years, reaching almost GBP48 million in FY2014. The low-risk social housing lettings contributed 88% of PHL's turnover in the latest financial year, which compares favourably to rated peers' 2014 average of 81%. The higher proportion is credit positive as it generally indicates enhanced stability and predictability of association's cash flows. The remainder of PHL's turnover was derived from first-tranche shared ownership sales (FTSO, 6%), properties rented for commercial purposes, including garages (3%) and other, mostly regeneration-related, activities. PHL's sales exposure remained modest compared to rated peers, who generated on average 11% of their turnover from built-for-sale activities in FY2014.

PHL projects that its total turnover will grow steadily over the next five years to around GBP60 million by FY2019,

driven primarily by newly build social housing units and regular inflation-linked rental increases. The revenue from FTSO sales is projected to be minimal over the next five years, with a peak of approximately GBP2 million and GBP3 million in FY2016 and FY2019 respectively. However, the projections do not include turnover from 105 outright sales units that are built in PHL's 50% joint venture. The units are currently being marketed, with 85 already sold or reserved, confirming strong demand in PHL's areas of operations. The expected turnover from all units is around GBP30 million, but PHL business plan only accounts for approximately GBP5.5 million of surplus being gift aided back to PHL. The latest forecasts indicate that the projected surplus will be outperformed. PHL's turnover from market rent is projected to increase to around 7% by FY2017 from 3% in FY2014, which is high compared to peers (2% in FY2014), increasing future exposure to non-core activities.

FAVOURABLE GEOGRAPHIC LOCATION

PHL is a former Large Scale Voluntary Transfer (LSVT) managing around 9,000 homes as at March 2014. Between 1998 and 2009 London Borough of 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 provider of social housing 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. Tower Hamlets is an area of buoyant housing demand, partially due to its proximity to thriving Canary Wharf area, which mitigates sales or private rent risk involved in some of PHL's development schemes.

PHL has two active subsidiaries. Poplar HARCA (Developments) Ltd. is a trading company which owns a near-complete development at William Cotton Court and also contains a 50% joint venture with Willmott Dixon Group, Aberfeldy New Village LLP. The joint venture was set up to undertake a large regeneration project consisting of delivery of around 1,200 new housing units over 10 years, including affordable rent units as well as homes for market rent and outright sales. Leaside Regeneration Ltd. is a company with charitable objective limited by guarantee, which came under Poplar HARCA's control in January 2012.

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 (GBP4,541 million at FYE2013) 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 (88% for Poplar HARCA), 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 25% of PHL's total income, compared to 29% average for Moody's-rated peers.

WEAK FINANCIAL PERFORMANCE, HIGHLIGHTED BY LOW OPERATING MARGINS AND THIN INTEREST COVER RATIOS

PHL's operating margins have stayed significantly below the median of rated peers over the last five years and have not kept pace with a significant growth in debt that has almost doubled over the same period. This resulted in an abrupt deterioration of PHL's interest cost cover ratios. This adverse trend is constraining the rating. The financial results for FY2014 has show signs of reversal, however, PHL's business plan suggests that a significant

improvement in its operating performance is unlikely in the near term.

PHL's operating margin averaged 14% of turnover over the period of FY2010-14, while the median for rated peers over the same period was 25%. The weaker performance was primarily driven by higher (1) management costs per unit, (2) rent arrears, and (3) maintenance spend compared to rated peers and also by a sizeable community regeneration-related spend. Despite a solid improvement in FY2014 (18% from 7% in FY2013) due to a GBP4 million drop in maintenance spend, operating margin has remained well below the rated peers' 2014 average of 29%. PHL's interest costs (cash basis) have increased by more than 100% since FY2010, which gradually eroded its social-housing-letting interest-coverage ratio (including depreciation) to 0.6x in FY2014 from 1.8x in FY2010 and the recurrent cash-interest coverage ratio to 1.0x from 1.7x. PHL's FY2014 performance was effected by one-off breakage costs (around GBP5.5 million) incurred as part of refinancing following PHL's bond issue in July 2013. Excluding this one-off, the coverage ratios would have reached 0.9x and 1.6x respectively, while rated peers' averages stood at 1.4x and 2.2x in FY2014. Even with the breakage costs, PHL's total margin remained positive in FY2014 (1%) despite PHL's projecting to record a negative margin of 12% in that year, which would have marked it as an outlier among its rated peers.

The rating also factors in the future financial performance as projected by PHL, which shows total and operating margin to remain around current levels in FY2015. Consequently, operating margin is projected to improve significantly to levels around 25% in FY2016 and to 28% by FY2019. The increase is contingent upon a successful handover of around 160 private rent and some 70 affordable rent units built as part of the Aberfeldy New Village development and reducing planned maintenance by 75%. However, the increase in margin is likely to be offset by a further increase in financing costs attributable to sale and leaseback transaction that PHL plans to enter into in FY2016 to fund the aforementioned 230 rental units. As a result, PHL's total margin is projected to hover around 1% and social housing interest coverage around 0.8x over the period of FY2015-19 (trough: 0.6x in FY2015, peak 0.8x in FY2016).

PHL's latest base case financial projections include an increase in its social rents by an additional GBP2 a week on top of the regular inflation-linked increases. This measure was historically in place to accelerate providers' effort to reach target social rent in their respective area. However, it has been removed from the official rent setting rules effective FY2016. PHL has applied for an exemption and is currently waiting for a decision. The inclusion of the yet-to-be-confirmed rent increases in the business plan makes PHL susceptible to a potential cumulative revenue loss of 4 million between FY2016-19 compared to its latest projections. PHL's own stress testing shows that not receiving the exception would put it at risk of breaching lenders' interest cover covenant in FY2020, if it failed to reduce its costs by the equal amount. However, we note that this downside potential is mitigated by prudence applied to other assumptions, including LIBOR rate increasing to 1.5% in 2014/15 and 5% by FY2019 (currently at around 0.5%); staff costs increasing above inflation at RPI+1%; and voids and bad debts more than doubling to 2.6% (0.9% as of FY2014) of gross rental income in response to possible impact of Welfare Reform. Should the assumptions fail to provide a sufficient buffer, management noted that the negative financial impact could be contained by reducing PHL's relatively sizeable discretionary expenditure such as maintenance or regeneration and community development spend.

HIGH AND RISING DEBT LEVELS, WHICH LIMIT POTENTIAL FOR ACCESSING ADDITIONAL LIQUIDITY, IF NEEDED

PHL's debt has been growing steadily over the last five years and reached levels that are high compared to rated peers. It was primarily used to fund PHL's extensive refurbishment programme, reflecting its status as a maturing LSVT. Currently, new debt is being used to finance PHL's community regeneration and growth strategy, which also includes gradual expansion into private rent and outright sales. PHL's projects that its debt will keep increasing until FY2016. The high debt left PHL with relatively low stock of unencumbered assets that could be used to source additional funds, however, its immediately available liquidity was adequate as of July 2014.

The association's debt has increased by approximately 80% since FYE2010, reaching GBP242 million or 5.1x turnover and 59% of assets (at cost) at FYE2014, which is above FYE2014 averages of its rated peers of 4.3x and 48%, respectively. Net capex averaged 67% of turnover over the last five years, well above 30% for rated peers, and was the main factor behind the debt growth. Although PHL issued a GBP140 million public bond in July 2013, it did not cause a surge in debt as GBP133 million was used to refinance legacy bank loans and to remove associated restrictive loan covenants, including limitations on additional borrowing. Going forward, PHL expects its debt to grow to around 6x revenues and 65% of assets by FYE2016 as a result of the lease and leaseback deal planned for FY2015 and some draw downs on its revolving facilities. Net capex is projected to reach its peak of 106% in FY2016, followed by a sharp decline to only 10% on average over FY2017-19. Consequently, debt is projected to gradually decline to around 5x turnover by 2019. Debt to assets, however, is likely to remain around the peak levels as PHL anticipates only very limited increase in its retained surpluses.

The aforementioned bond issuance led to a significant reduction of interest rate risk. The proportion of fixed rate debt now stood at 87% of total debt as of July 2014 and was in line with rated peers. As PLH plans to draw on its variable rate revolvers to fund its development pipeline, the proportion should change over time and become more in line with PHL's target of 50-80% fixed rate. The hedging portfolio does not include any standalone swaps, avoiding margin call risk.

PHL's unencumbered assets, which could be leveraged to access for additional debt funding, were estimated at GBP59 million as of July 2014 (Existing Use Value for Social Housing basis) or 107% of revenues, which is low compared to current rated peers average of 208% of revenues. This is partially offset by PHL's GBP36 million of immediately available liquidity, represented by cash and undrawn facilities, which equals 75% of turnover and is closer to rated peer's average of 98%. The current level of liquidity is adequate to PHL's position among rated peers, however, should immediate or potential liquidity materially deteriorate, this could have an impact on PHL's credit quality.

PHL maintains a formal Treasury Management Policy, which was updated in August 2014 following the bond issuance. The latest update strengthened the policy by introducing specific liquidity requirements, which are linked to level of activity. Management targets cash on hand of approximately GBP1 million, loans capable of drawdown within two days sufficient to cover six months of net cash requirement, increasing to 18 months for loans not capable of immediate drawn down. Latest data indicate that PHL is compliant with the policy as cash on hand was GBP3.2m at July 2014 and immediately available facilities were sufficient to cover more than 24 months of cash requirement (factoring in expected gift aid and sales income).

ADDITIONAL COMPLEXITY AND SALES RISK FROM A SIZEABLE DEVELOPMENT PROJECT CARRIED THROUGH A JOINT VENTURE AND PARTIALLY FUNDED BY AN RPI-LINKED LEASE AND LEASEBACK SCHEME

PHL's has demonstrated its commitment to regenerate its neighbourhood, which will also allow it to grow its asset base. Its flagship projects now include William Cotton Court, which is close to being delivered, and most importantly Aberfeldy New Village (Aberfeldy). The Aberfeldy development is carried out by PHL's commercial arm, Poplar HARCA (Developments) Ltd, via a 50% joint venture (JV) with Willmott Dixon Group, an established development company. It is a large regeneration project that promises to deliver around 1,200 new housing units over 10 years. To limit the overall exposure, PHL structured the project into six phases with an ability to not pursue the next stage should the market conditions deteriorate, without an adverse impact on the overall project. Although it is contained within the JV, the project adds some outright sales risks to PLH's operations in various phases. Phase 1a, for example, consists of delivering 105 units for outright sales by December 2014. This stage is progressing well with 85 units reserved as of September 2014. As PHL's business plan assumes that this phase will generate profit of GBP5.5 million, not realising the sales might have direct impact on PHL's financials. Phase 1b, which consists of around 160 market rent and 70 affordable rent scheduled for delivery by September 2015, is fully funded via a 30 years RPI-linked lease and leaseback, which increases PHL's exposure to market fluctuations and limits predictability of future funding costs. The risk is mitigated through (1) indexation being capped at 4.5%, (2) market rental rates experiencing strong growth since the project appraisal, providing upside to future cash flows, and (3) PLH's effort to match RPI-linked lease payments with RPI-linked rental income.

Although this structure increases governance complexity and limits direct control, we note that PHL has full visibility of the joint venture activities, including regular participation in JV's board meetings. In addition, cooperation with an established developer allows PHL to take advantage of their established supply channels and development expertise.

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

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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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