MOODY'S
PUBLIC SECTOR EUROPE

Rating Action: Moody's Public Sector Europe (MPSE)Moody's Public Sector Europe affirms A1 rating with negative outlook to Bromford Housing Group, ahead of planned merger with Merlin Housing Society

27 Jun 2018

London, 27 June 2018 -- Moody's Public Sector Europe (MPSE) MPSE has today affirmed the long-term issuer rating, the debt rating and the outlook of Bromford Housing Group Limited (BHG), of A1 with a negative outlook, ahead of its planned merger with Merlin Housing Society (Merlin) (unrated), a traditional social landlord with 8,500 units under management, a strong focus on social housing letting and a record of achieving targeted efficiency savings. The merger will see BHG remain as the parent of the group, within which Merlin will become a subsidiary, to establish one of the largest housing associations operating in the Midlands and the West of England.

RATINGS RATIONALE

Moody's expects the combined entity to retain the credit profile of BHG on a standalone basis, and continue the direction of travel of the business which is currently reflected in the assigned negative outlook. In FY2017, Merlin had notable idiosyncratic strengths, such as sourcing 94% of turnover from stable and profitable social housing letting, very high interest cover ratios relative to our rated portfolio, and low levels of debt. However, Merlin's strengths do not materially impact BHG's key metrics, due to its relatively small scale.

The new entity will retain BHG as the parent company to three registered providers in a straight forward structure, which will consolidate governance, and establish one of the largest provider of social housing in the Midlands, with over 39,000 units under management in total. The merged entity has scaled up planned development by approximately 2,100 additional units by 2022; an increase of 50% on BHG's previous development programme, thus continuing BHG's growth ambitions. While leadership has put in place sophisticated treasury policies to ensure adequate liquidity buffers are established, we note BHG's change in strategic direction incorporates increased development and market risk.

The combined business plan would improve the forecast operating margins for BHG as a standalone entity, to 31% in FY2019 from a forecast 26%, which is above median forecast margins for rated peers. Moreover, the merged entity would boost BHG's current unencumbered asset position, increasing BHG's borrowing capacity from GBP183m as at January 2018 as a standalone entity, to GBP282m upon the merger being complete, based on an Existing Use Valuation (EUV). BHG have been able to secure Market Value (subject to tenancy) (MV-T) evaluation on a proportion of assets secured against the entity's recent bond issuance and revolving credit facilities. Securing MV-T valuations would further enhance the value of BHG's unencumbered assets. We note, however, that the growth ambitions of the merged entity are likely to lead to additional borrowing throughout the life of the business plan, which would place pressure on its unencumbered asset position. BHG are establishing a treasury strategy to address these pressures going forward.

The affirmation of the rating also takes into account the new entity's credit challenges. These include implementation risk related to the establishment of a new coterminous board and changes to the executive team, alongside the roll out of a business transformation programme, which includes an upgraded group-wide IT system, and execution risk on the new entity's development programme, which targets delivery of some 6,300 homes by 2022. Over a third of the planned development will have market sales exposure, which incorporates market risk into BHG's activities. Furthermore, the group's debt level is set to increase, pushing gearing metrics to above rated peer levels, and weakening debt-to-revenue levels, the performance of which will be contingent on the housing association achieving the forecast revenues that are increasingly subject to cyclical forces.

As per the application of Moody's Joint Default Analysis methodology for government-related issuers, BHG's assigned baseline credit assessment (BCA) is a2. The final rating of A1 incorporates the one-notch uplift provided by Moody's assessment of a strong likelihood of support from the UK government.

RATIONALE FOR THE NEGATIVE OUTLOOK

The outlook on BHG's rating is negative, reflecting our expectation that the new entity will continue the direction of travel undertaken by BHG as a standalone entity, with financial metrics weakening from previously exceptional levels.

WHAT COULD CHANGE THE RATING -- DOWN/UP

A combination of the following could have positive rating implications: (1) a scaling back of the entity's development programme, with a corresponding reduction in market sales units; (2) enhancing and maintaining social housing social letting interest cover (SHLIC) to 2x or above; and (3) reduced projected borrowing, leading to a reduction in debt to revenue to 3.5x or below, and a lower of gearing to 45% or below.

Negative pressure could be exerted on the rating by one or a combination of the following: (1) a scaling up of the development programme and risk appetite; (2) an increase in debt, as shown by a weakening in debt-to-assets and/or debt-to-revenue metrics; (3) a worsening in BHG's unencumbered asset position; and (4) merger implementation issues relating to the transition of staff and internal processes.

In addition, a weaker regulatory framework, a dilution of the overall level of support from the UK government or the weakening of the UK's credit profile leading to a sovereign rating downgrade would also exert downward pressure on the rating.

The methodologies used in these ratings were European Social Housing Providers published in April 2018, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

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