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CREDIT OPINION
7 November 2018

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RATINGS

Bromford Housing Group Limited

Domicile	United Kingdom
Long Term Rating	A1
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Bromford Housing Group Limited

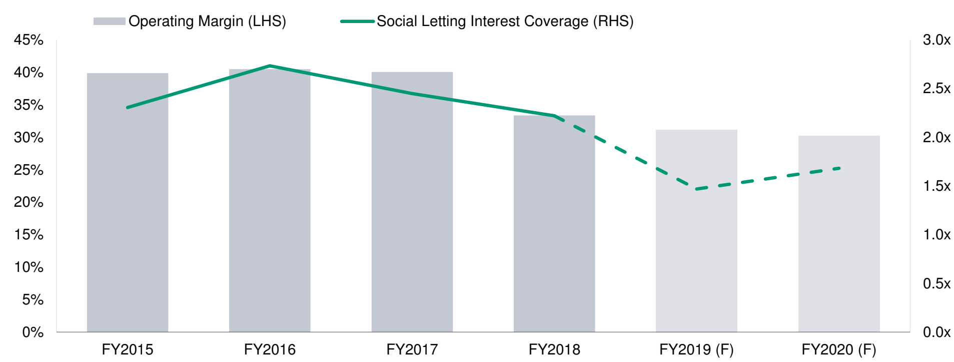
Update to credit analysis

Summary

The credit profile of Bromford Housing Group Limited (BHG, A1 negative) reflects our expectation that BHG's credit metrics will decline to be more closely aligned with those of its A2 peers over the next few years because of its declining operating margin and interest coverage ratio, increased debt and a growing share of revenue coming from market sales. BHG benefits from the strong regulatory framework governing English housing associations (HAs) and our assessment that there is a strong likelihood that the Government of United Kingdom (Aa2 stable) would intervene in the event that BHG faces acute liquidity stress.

Exhibit 1

BHG's strong profitability and interest cover are set to decline over the next two years



Note: BHG standalone financials for fiscal 2015-18; the merged entity's board-approved business plan for fiscal 2019-20.
Source: Moody's Investors Service, BHG

Credit strengths

» Simple group structure, with strong practices and procedures

» Relatively strong margins and interest cover, although both expected to weaken

» Strong regulatory framework

Credit challenges

» Increased debt levels following bond issuance

» Rising exposure to market sales and substantial growth in planned capital spending

» Operating environment remains difficult, but policy environment is more stable

Rating outlook

In July 2018, Bromford merged with Merlin Housing Society Limited (Merlin), leading to an enhancement in unencumbered assets and a stronger market position. However, the negative outlook on BHG's rating reflects our expectation that the merged entity's key credit metrics will decline to levels more closely aligned with those of its A2 peers.

Factors that could lead to an upgrade

A combination of the following could have positive rating implications:

» scaling back the entity's development programme, with a corresponding reduction in market sales units

» enhancing and maintaining social housing letting interest cover (SHLIC) at 2x or above

» reducing projected borrowing, leading to a reduction in debt/revenue to 3.5x or below and lowering gearing to 45% or below

Factors that could lead to a downgrade

Negative pressure could be exerted on the rating by one or a combination of the following:

» scaling up of the development programme and risk appetite

» increasing debt, resulting in a weakening in debt/assets or debt/revenue, or both

» reducing unencumbered assets

» higher-than-expected operating costs arising from merger implementation issues

Key indicators

Exhibit 2

Bromford Housing Group

	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19*	31-Mar-20*
Units under management (no.)	28,497	28,753	29,110	29,510	30,096	43,266	44,866
Operating margin, before interest (%)	36.7	39.9	40.5	40.0	33.3	31.2	30.2
Social housing letting interest coverage (x times)	2.1	2.3	2.7	2.4	2.2	1.5	1.7
Cash flow volatility interest coverage (x times)	2.6	2.6	3.3	3.1	2.4	2.0	2.1
Debt to revenues (x times)	3.5	3.4	3.4	3.4	3.6	4.3	3.9
Debt to assets at cost (%)	38.4	36.8	35.3	35.2	36.1	43.8	46.3

BHG standalone financials for fiscal 2015-18; the merged entity's board-approved business plan for fiscal 2019-20.
Sources: Moody's Investors Service, BHG

Detailed credit considerations

The credit profile of BHG, as expressed in its A1 negative rating, combines (1) its current Baseline Credit Assessment (BCA) of a2, (2) our expectation that BHG's credit metrics will decline to levels more closely aligned with those of its A2 peers over the next few years, and (3) a strong likelihood of extraordinary support from the UK government in the event that BHG faces acute liquidity stress.

Baseline credit assessment

Simple group structure, with strong practices and procedures

Following the recent merger with Merlin Housing Society (Merlin), BHG's structure has remained fairly simple. BHG is the group parent consisting of a centralised co-terminous board and single management team that controls three asset-owning registered subsidiaries — Bromford Home Ownership Ltd, Bromford Housing Association Ltd and Merlin — as well as Bromford Developments Ltd, a company that develops and constructs homes for the group, and Bromford Assured Homes Ltd, a property investment company. BHG plans to further simplify the group structure, potentially consolidating the registered subsidiaries.

BHG maintains strong management practices and well-documented procedures. Management places high importance on the liquidity of its funds. The treasury policy for the fiscal year ended March 2018 (fiscal 2018) stipulates the need to keep on-hand facilities covering 18 months of expected spending, as well as an additional £25 million facility for contingency and sufficient liquidity to cover a 20% slippage in forecast sales income. The policy also stipulates that BHG should maintain an additional £15 million buffer above its net mark-to-market level, down from £40 million in previous years.

BHG is a large provider of social housing in England, with over 30,000 units under management in fiscal 2018. The now-complete merger with Merlin, an HA that operates in the same region as BHG, has increased total units under management by about 9,000 units. The merger will further enhance BHG's market position and will make it one of the largest HAs across the Midlands and the West of England.

As with any merger, there are implementation risks associated with combining two organisations. BHG is currently in the process of consolidating the IT infrastructure of both organisations, through the HA's Programme One initiative, and rolling out new systems that may prove difficult to align. There will also be additional costs in the first few years by way of redundancies, hiring more "Neighbourhood coaches" and treasury costs associated with gaining merger consent. BHG has been prudent in its forecasting and recognises that the merger will not bring net savings until at least 2021. Annual net savings from merger synergies and updated IT infrastructure is expected to be around £3 million from 2021 onwards.

Relatively strong margins and interest cover, although both expected to weaken

BHG's financial performance in fiscal 2018 remained strong relative to that of its rated peers, with its operating margin at 33%. While this operating margin was above the rated-peer median of 31% for the year, it was significantly lower BHG's previous average of 40%, achieved between fiscal 2015 and fiscal 2017. Similarly, BHG's SHLIC ratio, at 2.2x in fiscal 2018, has been among the highest in our portfolio, but this metric is currently declining — from an average of 2.6x during the two previous fiscal years to a projected 1.5x in fiscal 2019 — placing BHG's SHLIC in line with those of its A2-rated peers. The forecast weakening in BHG's SHLIC in fiscal 2019 will be driven by the HA's current plan to reduce social housing letting (SHL) revenue as a proportion of revenue, coupled with interest costs growing by 59% in the year, as they include Merlin's interest costs and an increase in planned borrowing costs in the year. We note that interest costs are set to grow at a more gradual rate from fiscal 2020, that is in line with growth in SHL revenues, thereby stabilising SHLIC at 1.7x.

Total revenue was £174 million in fiscal 2018, a 4% increase from the previous year. Overall turnover growth has slowed since the introduction of the rent cut regime in fiscal 2016, which has hindered social housing letting revenue growth. As such, BHG's social housing letting revenue grew by a marginal 1% (£145 million) this in fiscal 2018, while overall turnover growth was driven by revenue from first tranche shared ownership (FTSO), which grew by 41% to reach £22 million. Turnover was further buoyed by BHG's strategic decision to reduce involvement in loss-making Supporting People contracts.

In addition to revenue pressures from the rent cut regime, which hurt the wider HA sector, BHG's operating margin was tightened by growing operating costs related to its investment in the "Neighbourhood Coaching programme" and new "Programme One" IT systems. These investments are planned to realise about £13 million in efficiency savings over a 12-year horizon, enhance customer satisfaction and lower voids in the medium term. Additionally, BHG paid £4 million as a one-off cost related to aligning operating models with Merlin, which are projected to deliver efficiencies of around £1 million per year. Collectively, these measures led operating costs to rise by 16% to £116 million in fiscal 2018.

Operating margins are forecast to gradually reduce, before stabilising at approximately 30% from fiscal 2020. Although this margin is lower than historical levels, it remains in line with the A1-peer median of 30% for the year. As such, we expect BHG's operating profitability and interest coverage ratio to remain strong compared with those of its peers, but to weaken from the record highs reported over the last few years. We expect this weakening, although from a strong base, to be driven by the difficult operating environment for BHG's core business, as well as incremental increases in market sales, which have lower margins, and BHG's medium-term investment in efficiency saving initiatives and its "Neighbourhood Coaching" programme - in which the group is investing in its frontline tenant services, and is employing over 100 additional staff to account for the increased housing stock gained following the merger. We note that BHG's investment in efficiency saving initiatives (such as Programme One and other merger synergies) and its

“Neighbourhood Coaching” programme will increase the group's cost base by a total of £4.6 million between fiscal 2018 and fiscal 2021, but should yield annual savings of approximately £3.3 million in real terms, from fiscal 2022.

Strong regulatory framework

The sector's credit quality will continue to benefit from the strong regulatory framework and oversight by the Regulator of Social Housing (RSH). The RSH became an established standalone organisation in October 2018 and will maintain strong oversight through quarterly returns, long-term business plans and annual reviews and by undertaking in-depth assessments of entities where deemed necessary. Additionally, the RSH is empowered to appoint board members and managers in the event of a breach of regulatory standards.

Increased debt levels following bond issuance

BHG's bond issuance of £300 million in May 2018 and its amalgamation with Merlin has led to a weakening in its debt metrics. As of fiscal 2018, BHG's debt stood at £622 million (fiscal 2017: £563 million), translating into debt/revenue of 3.6x. BHG's business plan projects debt to increase to £1,061 million in fiscal 2019, increasing debt/revenue for that year to 4.3x. The merged entity's business plan outlines a continued increase in borrowing over the next four years to fund an extensive development programme, but forecast revenue from new development is expected to partially offset the increase in debt, thereby stabilising debt/revenue at 3.9x from fiscal 2020. The weakening of this metric places BHG in line with its A2-rated peers.

BHG's gearing (debt/assets at cost) increased marginally to 36% in fiscal 2018 from 35% in fiscal 2017; the ratio remains at the low end of the range for our rated portfolio. However, going forward, BHG's gearing metric is set to increase to 44% at fiscal 2019 and 46% at fiscal 2020. The increase in gearing is driven by incorporating Merlin's balance sheet into the group (Merlin's gearing was at 51% at fiscal 2018), as well as the projected debt increase. As planned borrowing increases for the HA, this metric is expected to further weaken gradually.

Refinancing risk remains moderate, with 95% of BHG's outstanding debt due after five years. We consider interest rate risk to be low, as a total of 15% of BHG's debt stock is subject to variable rates, however 8% (percentage points) of variable debt is swapped to fixed rate in BHG's swap portfolio, equating to a total of 93% of the group's debt set at fixed rates. BHG's management continue to take advantage of low values of options and buying out of cancellable swaps, and maintain sufficient security (£37.5 million of security charged against a negative mark-to-market position of £23.8 million as of 31 July 2018) ready to meet margin calls.

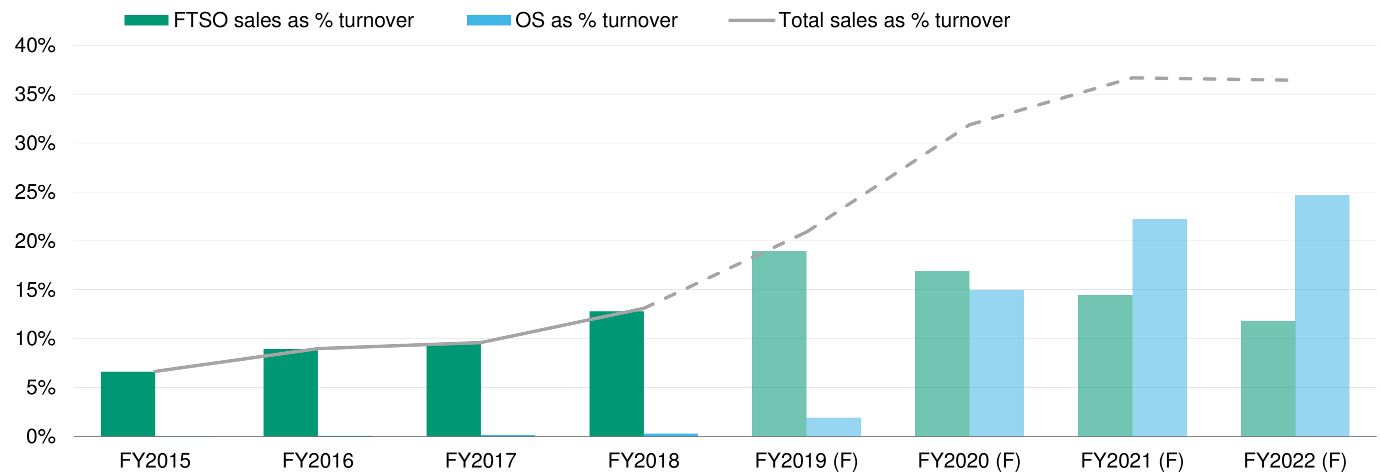
Rising exposure to market sales development and substantial growth in capital spending

BHG has historically generated a large share of its revenue from core social housing letting, averaging 85% between fiscal 2015 and fiscal 2017, which was above the A1-rated peer median of 81% during the same period. However, social housing letting as a percentage of revenue is projected to decline for BHG to 76% in fiscal 2019 and 66% in fiscal 2020, as the HA increases its sales programme to cross-subsidise social housing. In fiscal 2018, sales revenue (first tranche of shared ownership and outright sales) constituted 13% of BHG's turnover, up from 10% in the previous year. BHG's current business plan projects this figure will increase to 21% in fiscal 2019 and 32% in fiscal 2020, and continue to increase up to fiscal 2022. In the near term, sales revenue will come almost entirely from first tranche shared ownership (FTSO) sales. However, from fiscal 2021 onwards, most of the revenue will come from outright market sales (Exhibit 3). We expect the potential increase in this revenue stream to add to credit risk, given the susceptibility this type of activity has to market forces and the increased volatility in cash flow compared to revenue from social housing letting. However, following the completion of the merger between BHG and Merlin, the HA has stated it may revisit the tenure mix of its business plan over the next year.

Exhibit 3

Market sales as a proportion of revenue set to continue to increase, driven by outright sales

Market sales as proportion of revenue (%) by source



Source: Moody's Investors Service, BHG

BHG intends to use sales revenue to support its core social rented business, and this is reflected in the tenure mix of the development programme, with 66% of planned development over the next five years committed to social rented properties, 23% to shared ownership and the remaining 11% to open market sale. In relation to the development programme, BHG expects net capital spending to rise significantly, from £60 million in fiscal 2018 to £213 million in fiscal 2019, equivalent to 86% of turnover. The aforementioned lower margins from market sales, coupled with the increase in net capital spending and borrowings of the merged entity, are set to weaken BHG's currently strong financial metrics, which is a key credit concern (see Exhibit 2).

Partially mitigating this exposure to increased net capital spending is the HA's board-approved liquidity policy. Our liquidity coverage metric, which measures BHG's ability to cover its significant increase in net capital spending projected over the next two years with immediately available liquidity, was set at 1.4x in fiscal 2018. As net capital spending rises sharply in the coming years, BHG's liquidity coverage remains slightly above 1.0x in fiscal 2019, providing sufficient coverage over the following two years.

Operating environment remains difficult but policy environment is more stable

We do not expect additional material adverse policy shifts for the sector and consider the operating and policy environment stable in the medium term. Adverse policies announced in the last few years — especially the effects of the 1% annual decrease in social rents (until fiscal 2020) and Universal Credit (a pillar of broader welfare reform measures) — will continue to hurt revenue. However, HAs have demonstrated resilience to adverse policies to date and been proactive in mitigating such impact. A reduction in capital grant for new social housing over the last five years has led to increased exposure to market sales activity, which reached 31% of turnover in fiscal 2017 for the HAs we rate. The credit risk associated with exposure to market sales is incorporated in the BCAs.

Extraordinary support considerations

The strong extraordinary support factored into the rating reflects the wide-ranging powers of redressal available to the regulator in the event 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 assumption also factors in (1) the increasing exposure to non-core social housing activities in the sector, which adds complexity to HA operations, and (2) the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more difficult. In addition, our assessment that there is a very high default dependence between BHG and the UK government reflects their strong financial and operational links.

Rating methodology and scorecard factors

The assigned BCA of a2 is close to the scorecard-suggested BCA of a3.

The methodologies used in this rating are European Social Housing Providers, published April 2018 (Report Number: 1113602) and Government Related Issuers, published in June 2018 (Report Number: 1104983).

Exhibit 4
BHG Baseline Credit Assessment Scorecard

Bromford Housing Group			
Baseline Credit Assessment	**Sub-factor Weighting**	**Value**	**Score**
Scorecard			
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	30,096	a
Factor 3: Financial Performance			
Operating Margin	5%	33.3%	a
Social Housing Letting Interest Coverage	10%	2.2x	aa
Cash-Flow Volatility Interest Coverage	10%	2.4x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	3.6x	baa
Debt to Assets	10%	36.1%	baa
Liquidity Coverage	10%	1.4x	a
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**a3**

Sources: Moody's Investors Service, BHG

Ratings

Exhibit 5

Category	Moody's Rating
BROMFORD HOUSING GROUP LIMITED	
Outlook	Negative
Issuer Rating -Dom Curr	A1

Source: Moody's Investors Service

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