MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
7 October 2020

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RATINGS

Optivo

Domicile	United Kingdom
Long Term Rating	A3
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

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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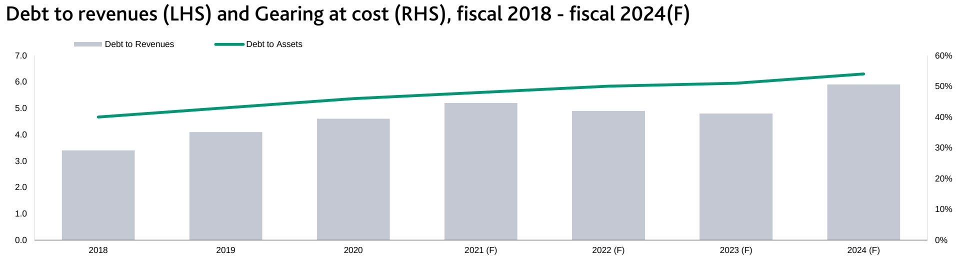
Optivo

Update following downgrade to A3 stable

Summary

The credit profile of Optivo (A3 stable) reflects a business model supported by a core of low-risk social housing letting, strong market position as a large housing association (HA) based in London and South East England, a large balance sheet including a strong unencumbered asset position and ample liquidity to complete committed development schemes. It also takes into account Optivo's rising debt levels and weakening interest coverage and its exposure to the cyclical housing market through market sales. The credit profile also incorporates the strong likelihood that the Government of United Kingdom (Aa2 negative) would intervene in the event that the association faced acute liquidity stress.

Exhibit 1
Optivo's debt metrics are projected to rise to finance its development programme
Debt to revenues (LHS) and Gearing at cost (RHS), fiscal 2018 - fiscal 2024(F)



Source: Optivo, Moody's Investors Service

Credit strengths

» Large HA with strong balance sheet and core social housing business

» Sufficient liquidity and sound policies

» Supportive institutional framework in England

Credit challenges

» Significant development programme, focussed on social rent and shared ownership

» Weaker margins and higher debt lowering interest coverage

Rating outlook

The stable outlook on Optivo's rating reflects the view that the planned increase in borrowing and consequent impact on debt and interest cover ratios is balanced by the organisation's large size and resilient balance sheet.

Factors that could lead to an upgrade

An upgrade in the near term is unlikely given the downgrade and forecasted increase in debt. However, upward pressure could result from much slower debt growth; significant decrease in development ambition; and improvement in interest cover ratios and liquidity.

Factors that could lead to a downgrade

The rating could face downward pressure from one or a combination of the following: a significant increase in debt higher than currently projected; sustained weak operating margins and interest cover ratios lower than currently projected; an increase in market sales exposure as a percentage of total revenues significantly above current projections. In addition, a weaker regulatory framework or a dilution of the overall level of support from the UK could also exert downward pressure on the rating

Key indicators

Exhibit 2

Optivo

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21 (F)	31-Mar-22 (F)
Units under management (no.)	41,903	41,896	42,133	42,240	42,568	42,345	43,074
Operating margin, before interest (%)	28.0	35.0	30.5	28.5	22.6	21.3	20.9
Net capital expenditure as % turnover	40.2	9.3	29.2	76.9	57.1	81.5	84.0
Social housing letting interest coverage (x times)	1.6	1.8	1.8	1.6	1.2	1.1	1.1
Cash flow volatility interest coverage (x times)	2.0	2.5	1.7	0.4	1.1	1.0	1.0
Debt to revenues (x times)	3.6	3.1	3.4	4.1	4.6	5.2	4.9
Debt to assets at cost (%)	45.1	40.1	39.7	43.3	45.5	48.2	50.3

Optivo's pro forma accounts (2016), Optivo's financial statements (FY2017-20), Optivo's business plan (FY2021-22)
Source: Optivo, Moody's Investors Service

Detailed credit considerations

On 2 October 2020, Moody's downgraded Optivo's ratings to A3 from A2 and changed the outlook to stable. The downgrade reflected the weakening in Optivo's financial metrics, which we expect to remain more closely aligned with A3 peers. Optivo's debt has grown to support its development programme, while its interest cover metrics have declined. Weaker operating margins alongside continued debt growth to support development will continue to pressure interest covers and operating cash flows.

Optivo's rating combines (1) a Baseline Credit Assessment (BCA) of baa1, and (2) a strong likelihood of extraordinary support from the UK government in case of acute liquidity stress.

Baseline credit assessment

Large HA with strong balance sheet and core social housing business

Optivo has 42,500 units under management in fiscal 2020 and is a member of the G15, a group of sizeable and influential HAs in London. The organisation has significant housing assets valued at over £3.3 billion (at historic cost). As of fiscal 2020, 80% of Optivo's revenue came from its core business of providing social rented housing. Historically, Optivo recorded strong margins on its social letting business, averaging 31% over the time period spanning its merger in fiscal 2017 through fiscal 2019. In fiscal 2020, however, higher fire safety costs, maintenance spending and higher void loss resulted in a lower social lettings margin of 25%.

Optivo has some diversification in rented products, which includes a small portfolio of market rent, a modest amount of student accommodation, key worker accommodation and support products; Optivo has now exited the less-profitable specialized care and plans to dispose part of its student housing in fiscal 2021. In fiscal 2020, revenue from sales remained moderate at 9.6% of total revenue, but this proportion is expected to grow over the next three years to peak at 22% in fiscal 2023.

With a weaker social lettings margin, Optivo's operating margin declined to 23% in fiscal 2020 from 29% the year previous. Optivo has prudently incorporated continued higher fire safety works into higher expenses with slower cost recovery, which will pressure margins over the next few years. As a result, we expect Optivo's operating margins to remain lower over the next three years, presently projected to average 21% over fiscals 2021-23, before recovering in fiscal 2024.

Sufficient liquidity and sound policies

Optivo's level of unencumbered assets is strong, providing additional borrowing capacity of £930 million as of July 2020. The housing association's unencumbered assets cover the additional £711 million of debt that it plans to take on by fiscal 2024. Optivo used a portion of its unencumbered assets to put in place additional credit facilities, reinforcing the housing association's liquidity cover metric, forecast to average 1.1x over fiscals 2020-2022. As of July 2020, Optivo's liquidity was made up of £80 million in cash and £685 million in undrawn, immediately available facilities with a further £25 million in the process of being secured. In April 2020, Optivo issued a £250 million 2035 bond to strengthen its liquidity position, of which £100 million was retained. In May, it also accessed the Bank of England's Covid Corporate Financing Facility (CCFF), obtaining £150 million in unsecured financing, maturing in 2022. In September 2020, Optivo raised £150 million of 18 month deferred funding (to coincide with the maturity of the CCFF financing) via a tap of its 2043 bonds, with another £50 million retained.

Optivo's recently reviewed treasury policy is clear and robust, which will likely ensure that adequate liquidity is maintained. The policy specifies that £50 million in immediately available cash will be maintained, an amount which is monitored daily and reviewed quarterly with regard to debt servicing and capital expenditure needs, as well as the housing association's ISDA cash requirement.[1] A second liquidity test requires a minimum of £400 million of committed facilities and cash immediately available. This test was simplified compared to the previous iteration which stated that cash and secured facilities were to meet forecast cash needs for 12 months. The final test states that sufficient cash, committed loan facilities, and forecast reliable surpluses (net of scheduled loan repayments) must be available to cover all contractually committed development spending.

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong regulatory framework governing English HAs. The regulator maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and by undertaking biennial In-Depth Assessments (IDAs) for large and complex HAs. Some aspects of the regulator's oversight have been changed temporarily during the pandemic, for example, the programme of IDAs was temporarily paused and regulatory submissions delayed to reduce the operational burden on HAs. The regulator has a strong track record of intervention in cases of mismanagement or financial stress with powers to provide financial assistance and/or make manager appointments where there has been a breach of regulatory standards.

The operating environment for English HAs has improved under more supportive policies for social rent increases and capital grant. Following four years of social rent reductions, HAs now benefit from a return to inflation-linked rent increases from April 2020 for five years. In addition, the government has committed to increased capital grant on more flexible terms for new social housing.

Counterbalancing the improvements, we expect policy to drive increased borrowing and development risk in the sector as it responds to the government's objective to deliver a significant increase in the construction of new homes.

Significant development programme, focussed on social rent and shared ownership

Optivo's development programme following its 2017 merger targeted 1,500 units of starts per year, which it achieved in fiscal 2020 for the first time. Given weaker expected margins, however, Optivo has reduced its development programme over the near term in its latest business plan and will be further reviewing its development programme by the end of the year. In its latest business plan, approximately 5,400 units are expected to be started and 4,500 completed over the next five years (equating to 11% of existing stock). Optivo has deliberately reduced its exposure to outright market sales over the last year, with no new schemes contemplated. However, this exposure will still increase over the near term as planned development is completed with market sales peaking at 22% of turnover in FY2023 (up from 10% over FY2016-19), though this would be predominantly first tranche shared ownership. The increase in market sales exposes the group to increased volatility in its operating cash flows which is exacerbated by the current volatility in the housing market caused by the coronavirus outbreak and associated economic contraction.

With the development planned, net capital expenditure is forecast to average over 75% of turnover over fiscals 2021-2023, significantly higher than the average of 38% of turnover for fiscals 2017-2019. The increasing net capex and ambitious development programme brings development risk to the organisation.

As announced with the 2018 UK budget, Optivo will receive around £50 million of grant over the next five years for affordable housing as a strategic partner with Homes England. This will be in addition to the £57 million of grant which Optivo will receive as a strategic partner with the Greater London Authority (GLA). The grant from the GLA will fund homes in the London Affordable and Living Rent tenures, as well as shared ownership. Securing additional grant is credit supportive for Optivo and all development activity to fiscal 2023 is pre-funded with grant.

In terms of the tenure mix of the development programme, over half of properties to be built over the next five years are intended for social rented accommodation, which supports growth in the social rented revenue stream. Around 44% of completions over this period are planned to be shared ownership and 5% outright sales. Optivo has a strong focus on building properties in the London area, with a little over half of the programme expected to be in and around the capital. The more volatile nature of the housing market in London and South East, however, is a credit concern for HAs developing in these areas. As a mitigation, Optivo holds flexibility over its development programme with no committed development currently after fiscal 2022 and it has ensured that all shared ownership development is able to switch tenure if needed. Optivo converted 43 shared ownership units to social rent in fiscal 2020.

Weaker margins and higher debt lowering interest coverage

Optivo's margins are expected to weaken over the next three years, while its debt will continue to rise to fund its development programme. Consequently, interest covers will remain weaker. In FY2020, social housing letting interest cover was 1.2x, down from 1.7x over FY2017-19, and is projected to be around 1.1x over FY2021-24. CVIC has been volatile due to the ramping up of Optivo's development programme from a low base and significant unsold stock at FYE2019 and 2020. However, as new social housing units are built, this will increase social housing letting revenue and along with the completion of planned fire safety works, this should support margins and interest coverage from fiscal 2024.

Higher debt will also mean Optivo's debt-to-assets at cost ratio will deteriorate to 51% as of the end of fiscal 2023, from 46% as of the end of fiscal 2020. Debt to revenues will also deteriorate over the next three years, reaching 4.8x in fiscal 2023, from 4.6x in fiscal 2020 and higher than 4.1x in fiscal 2019. The debt trajectory is a constraint to Optivo's credit profile as debt metrics will remain more closely aligned to A3 rated peers. Debt is expected to peak in FY2026 with current development plans but would instead peak in FY2022 if no further development schemes were started.

Optivo's policy is to maintain moderate interest rate risk, which is reflected in the current debt structure. Approximately 94% of Optivo's net debt was fixed by a combination of fixed-term loans, derivatives (both standalone and embedded swaps) and cash balances. As of June 2020, the swap portfolio amounted to a relatively large notional value of £477 million, which had a negative mark-to-market of £179 million with ample property security (£288 million) charged to the position to cover any adverse fall in interest rates.

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 assumption also factors increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more challenging. In addition, our assessment that there is a very high default dependence between Optivo and the UK government reflects their strong financial and operational linkages.

ESG Considerations

How environmental, social and governance risks inform our credit analysis of Optivo

Moody's takes into account environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Optivo, the materiality of ESG to the credit profile is as follows:

Environmental risks are not material to Optivo's credit profile. Social rented homes in the UK are generally more energy efficient than privately rented and owner-occupied homes; additionally housing associations continue to invest in new stock and improving the energy efficiency of existing stock. In line with the rest of the UK, its main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by county and national authorities, and therefore the burden of adapting to increased flood risk will not fall on Optivo.

Social risks are material to Optivo's credit profile, in line with the rest of the UK housing association sector. In particular, the sector is exposed to risks stemming from socially-driven policy agendas and is also affected by the impact of demographic trends and customer relations on demand. Socially-driven policy agendas can be positive or negative for the sector. The broad political support for social housing is captured in our analysis of the operating environment. On the other hand, central government's policy to increase the affordability of rents for low-income social housing tenants led to four years of sector-wide rent cuts from fiscal 2017 which was credit negative for the sector. Customer relations and product quality can also have an impact on housing associations. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards, and led many housing associations to increase spending on the quality of their existing stock. Higher fire safety costs will weigh on Optivo's margins over coming years.

We view the coronavirus outbreak as a social risk under our ESG framework. We expect the pandemic to have material impacts on housing associations, however for the majority of HAs, including Optivo, we expect that they will be able to mitigate these impacts so that credit profiles are not significantly affected. We expect the main impacts will be through operational challenges, including staffing shortfalls and redeployment, and increases in rental arrears and voids in the short-term due to higher unemployment. However, we also expect that HAs, including Optivo, will temporarily be able to make cash savings on repairs and maintenance and slower development spending, which will support liquidity.

Governance considerations are also material supported by Optivo's responsive financial management and solid reporting and commitment to strengthening liquidity. English housing associations also benefit from a strong regulatory environment and close oversight by the Regulator for Social Housing, as detailed in the main body of this report.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

Rating methodology and scorecard factors

The assigned BCA of baa1 is the same as the scorecard-suggested BCA of baa1

Exhibit 3

Optivo			
Baseline Credit Assessment	**Sub-factor Weighting**	**Value**	**Score**
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	42,568	a
Factor 3: Financial Performance			
Operating Margin	5%	22.6%	baa
Social Housing Letting Interest Coverage	10%	1.2x	baa
Cash-Flow Volatility Interest Coverage	10%	1.1x	baa
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.6x	ba
Debt to Assets	10%	45.5%	ba
Liquidity Coverage	10%	1.0x	a
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**baa1**
Sources: Optivo, Moody's			

Source: Optivo, Moody's Investors Service

The methodologies used in this rating are European Social Housing Providers, published in April 2018 and Government Related Issuers, published in February 2020.

Ratings

Exhibit 4

Category	Moody's Rating
OPTIVO	
Outlook	Stable
Issuer Rating -Dom Curr	A3
OPTIVO FINANCE PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

Endnotes

1 Optivo's treasury policy stipulates a target of maintaining sufficient security in place to withstand a parallel 1% decline in interest rates of all maturities, or sufficient cash is held immediately available for this purpose.

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EMEA	44-20-7772-5454

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