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CREDIT OPINION
7 November 2018

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RATINGS

Optivo

Domicile	United Kingdom
Long Term Rating	A2
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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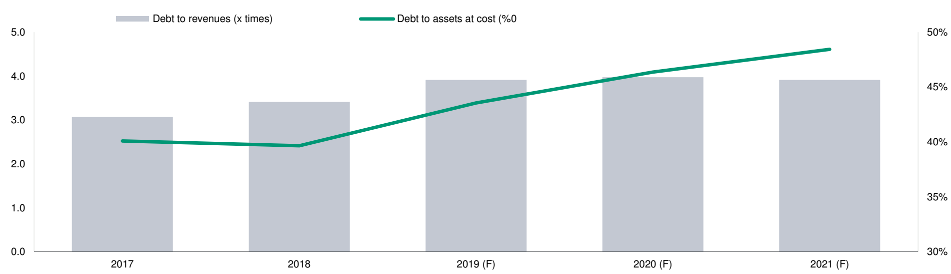
Optivo (United Kingdom)

Update to credit analysis

Summary

The credit profile of Optivo (A2 stable) reflects a business model supported by a core of low-risk social housing letting, expected strong interest coverage, and operating margins at par with the median for the housing associations (HAs) we rate. The credit profile also takes into account the strong likelihood that the Government of United Kingdom (Aa2 stable) would intervene in the event that the association faces acute liquidity stress. Credit challenges include rising debt levels in the medium term and exposure to the cyclical housing market through shared ownership units and planned market sale properties.

Exhibit 1
Optivo's debt metrics are likely to rise over the next few years to fund the development programme



Sources: Moody's Investors Service, Optivo's financial statements (2017-18), Optivo's business plan (2019-21[F])

Credit strengths

» Profitable core business, which supports interest coverage

» Sufficient liquidity and sound policies

» Strong regulatory framework

Credit challenges

» Scaling up of the development programme increases exposure to sales and development risk

» Debt increasing, albeit from a moderate level

» Operating environment remains difficult, but policy is more stable

Rating outlook

The stable outlook on Optivo's rating reflects the currently stable operating environment, which is unlikely to undergo further material changes in the medium term, and the stable outlook on the sovereign rating.

Factors that could lead to an upgrade

Positive pressure on Optivo's rating could result from one or a combination of the following: (1) social housing letting interest cover (SHLIC) coverage structurally at or above 1.8x, (2) strengthening of the cash flow volatility interest cover (CVIC) to or above 2.0x on a sustained basis, (3) liquidity coverage metric rising to and remaining above 2.0x, (4) a material scaling down of development, and particularly sales, ambitions.

Factors that could lead to a downgrade

Negative pressure could arise from one or a combination of the following: (1) a shift towards increasingly market-sales-oriented development, (2) an acceleration in debt growth, (3) a deterioration in the operating margin and weakening of interest coverage metrics, and (4) a weakening in liquidity.

In addition, a weaker regulatory framework, dilution of the overall level of support from the UK government or a downgrade of the sovereign rating could also strain Optivo's rating.

Key indicators

Exhibit 2

Optivo

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19 (F)	31-Mar-20 (F)	31-Mar-21 (F)
Units under management (no.)	41,903	41,896	42,133	42,141	43,432	43,542
Operating margin, before interest (%)	28.0	35.0	30.5	27.4	22.5	25.3
Net capital expenditure as % turnover	40.2	9.3	29.2	73.9	67.5	63.5
Social housing letting interest coverage (x times)	1.6	1.8	1.8	1.5	1.3	1.3
Cash flow volatility interest coverage (x times)	2.0	2.5	1.7	1.7	1.9	1.7
Debt to revenues (x times)	3.6	3.1	3.4	3.9	4.0	3.9
Debt to assets at cost (%)	45.1	40.1	39.7	43.6	46.4	48.4

Optivo's pro forma accounts (2016), Optivo's financial statements (2017-18), Optivo's business plan (2019-21).
Sources: Moody's Investors Service, Optivo

Detailed credit considerations

Optivo's A2 rating combines (1) a Baseline Credit Assessment (BCA) of a3, and (2) a strong likelihood of extraordinary support from the UK government in case of acute liquidity stress.

Baseline credit assessment

Profitable core business, which supports interest coverage

Around 81% of Optivo's revenue comes from its core business of providing social rented housing. The margin derived from social letting is robust, at around 32% in fiscal year ending 31st March 2018, and after a slight dip in the next couple of years, is forecast to remain at this level in FY2021 and beyond. The profitability of this core business supports Optivo's SHLIC, which stood at 1.8x in FY2018 (A2 peer median for FY2018: 1.9x).

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 the less-profitable specialized care and support products. In FY2018, revenue from sales remained moderate at 11% of total revenue, but this proportion will grow. Despite an increase in lower-margin sales activities and an increased sustainability budget over the next few years, the operating margin will remain aligned with that of Optivo's peer group.

Optivo was created from the merger of two housing associations (AmicusHorizon and Viridian) in May 2017. With over a year as a merged entity, the association has met integration milestones in terms of operations. During 2017-18, as a result of integrating Optivo's main housing management and finance systems, the association incurred a one-off merger cost of £2.1 million. Fully integrated IT systems are now operational, the staff restructuring was largely completed in September 2018 and the group expects to close the former Viridian head office in Clapham later this calendar year. As Optivo works through the implementation of planned efficiencies from the merger, profitability in the core business will increase, supporting the SHLIC. From March 2020 onwards, Optivo forecasts delivery of £10 million per annum in recurring savings as a result of the merger.

Sufficient liquidity and sound policies

Optivo's level of unencumbered assets is strong, providing additional borrowing capacity of £820 million as of July 2018. The housing association's unencumbered assets cover the additional £618 million of debt that it plans to take on by FY2021. In FY2018, Optivo used a portion of its unencumbered assets to put in place additional credit facilities, reinforcing the housing association's liquidity cover metric, forecast at 1.0x in FY2019. As of July 2018, Optivo's liquidity is made up of £71 million in cash and £502 million in undrawn, immediately available facilities.

Moreover, 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 will be 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 that cash and secured facilities meet forecast cash needs for 12 months. Furthermore, sufficient cash, facilities, reserved asset sales and forecast reliable surpluses (net of scheduled loan repayments) must be available to cover all contractually committed development spending.

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 (previously Homes and Communities Agency). The Regulator of Social Housing maintains strong oversight through quarterly returns, long-term business plans, annual reviews and undertaking in-depth assessments of entities where deemed necessary. Additionally, the Regulator of Social Housing has powers to make board member and manager appointments where there has been a breach of regulatory standards. From October 2017, the Regulator of Social Housing is charging fees for social housing regulation to enhance the independence and maintain the effectiveness of the regulator.

Scaling up of the development programme increases exposure to sales and development risk

Optivo's development programme targets 1,500 units of starts per year, and approximately 7,000 units are expected to be built over the next five years (equating to 17% of existing stock). While this was the target of the pre-merger business plan, the pace at which Optivo is approaching this target has accelerated, driven by the more rapid identification of development projects that fulfil the requirements set by the organisation's board and management. In addition to this, a higher cost per unit has been factored in by the planning team. Both of these factors contribute to higher net capital expenditure than previously projected. Net capex rises to an average of 69% of turnover over FY2019-22, significantly higher than the average 35% turnover for the same period forecast a year ago.

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. Details of this partnership have yet to be hammered out. 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. Overall, these partnerships mitigate political risk in the sector, as the links between government and housing associations remain an important component of the overall credit profile. Securing additional grant is credit supportive for Optivo, and may slow the accumulation of debt and decrease the amount of cross-subsidy needed from sales. However, by committing to higher development targets, housing associations raise their economic risk.

In terms of the tenure mix of the development programme, 50% of properties to be built over the next five years are intended for social rented accommodation (3,400 units), which supports growth in the social rented revenue stream. The development programme also includes a significant component of sales, with around 40% of the total programme dedicated to shared ownership (2,800 units), and the remaining for open market sales (600 units).

Sales revenue as a percentage of total, including outright sales and first-tranche shared ownership sales, will increase sharply to 29% in FY2022 from 11% in FY2018, further exposing Optivo to the cyclical housing market. Optivo has a strong focus on building properties in the London area, with 60% of the programme expected to be in and around the capital. The more volatile nature of the housing market in London and South East is a credit concern for the HAs developing in these areas[2]. Mitigating concerns of less stable future cash flow, Optivo's cash flow volatility interest cover is forecast to remain strong into the medium term, averaging 1.8x over FY2018-21. However, the development pipeline is expanding at a faster rate than previously expected, the board's approach to development will remain a credit factor.

Debt increasing, albeit from a moderate level

In March 2018, Optivo issued a £250 million bond, of which £100 million has been retained. The proceeds from the issuance are being used to repay a variable-rate credit facility, increasing the proportion of Optivo's fixed-rate debt, and to finance development spending.

Looking forward, to fund development, Optivo's debt-to-assets at cost ratio will deteriorate to 51% as of the end of FY2022, from 40% as of the end of FY2018. While this higher level of gearing is not inconsistent with the current rating level, this debt trajectory is a constraint to Optivo's credit profile.

Although gearing will increase, Optivo's policy is to maintain moderate interest rate risk, which is reflected in the current debt structure. Following the bond issuance in March 2018, around 97% of Optivo's net debt was fixed by a combination of fixed-term loans, derivatives (both standalone and embedded swaps) and cash balances. The swap portfolio amounts to a relatively large notional value of £425 million (down from over £600 million a year ago), which had a negative mark-to-market as of June 2018, of which £142 million was met with ample property security (£292 million) and a small amount of cash (£0.4 million).

Operating environment remains difficult, but policy is more stable

We do not expect additional material adverse policy shifts for the sector and expect the operating environment to be stable in the medium term. Adverse policies announced in the last few years will continue to hurt revenue, especially the 1% annual decrease in social rents (until FY2020) and Universal Credit (a pillar of broader welfare reform measures). However, HAs have demonstrated resilience to adverse policies to date and been proactive in mitigating the 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 more than doubled since 2012 to reach 18% of turnover for the HAs we rated in FY2017.

Extraordinary support considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers of redressal available to the regulator in case 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 increasing exposure to non-core social housing activities in the sector, which add complexity to HA operations, and 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 Optivo and the UK government reflects their strong financial and operational links.

Rating methodology and scorecard factors

The assigned BCA of a3 is aligned with the scorecard-suggested BCA of a3.

Exhibit 3
Optivo BCA Scorecard - FY2018

Optivo			
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%	42,133	a
Factor 3: Financial Performance			
Operating Margin	5%	30.5%	a
Social Housing Letting Interest Coverage	10%	1.8x	a
Cash-Flow Volatility Interest Coverage	10%	1.7x	baa
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	3.4x	baa
Debt to Assets	10%	39.7%	baa
Liquidity Coverage	10%	1.2x	a
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**a3**

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 June 2018.

Ratings

Exhibit 4

Category	Moody's Rating
OPTIVO	
Outlook	Stable
Issuer Rating -Dom Curr	A2
OPTIVO FINANCE PLC	
Outlook	Stable
Senior Secured -Dom Curr	A2

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.

2 See research piece: Migration and rental trends expose London and South East to house price pressures.

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