MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
18 November 2019

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RATINGS

Optivo

Domicile	United Kingdom
Long Term Rating	A2
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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Optivo

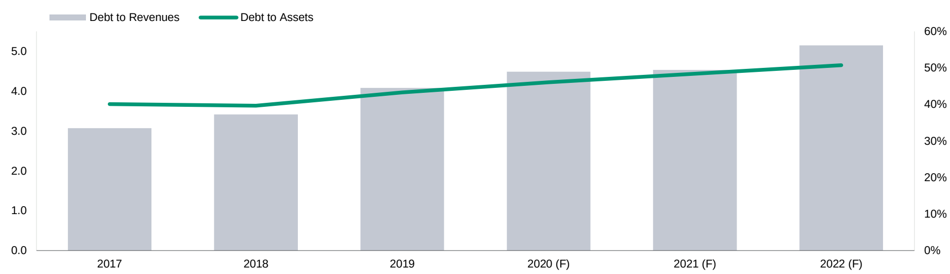
Update following rating affirmation

Summary

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

Exhibit 1

Optivo's debt metrics are forecast to rise to finance ambitious development programme
Debt to revenues (LHS) and Gearing at cost (RHS), fiscal 2017 - fiscal 2022(f)



Source: Optivo, Moody's Investors Service

Credit strengths

» Profitable core business, which supports interest coverage

» Sufficient liquidity and sound policies

» Supportive institutional framework in England

Credit challenges

» Scaling up of the development programme increases exposure to sales (first tranche shared ownership and outright sale) and development risk

» Debt increasing, albeit from a moderate level

Rating outlook

The negative outlook on Optivo's rating reflects the development ambition, in a context of a softening property market and weaker economic outlook, which will result in increasing debt levels, higher capital spending and development risk, as well as weaker interest coverage, with financial metrics moving to levels more closely aligned with A3-rated peers.

Factors that could lead to an upgrade

An upgrade is unlikely in the near term given the forecasted increase in debt and negative outlook. However, a stabilisation of the rating could result from: much slower pace of debt growth; significant decrease in development ambition; improvement in interest cover ratios and liquidity.

Factors that could lead to a downgrade

The rating could be downgraded if Moody's determined Optivo's strategy of a planned increase in debt and increase in market sales exposure to be unlikely to succeed in an uncertain and weakening macro environment. Optivo's debt burden is projected to increase with their increasing development ambition, which is weighing on their rating and will deteriorate their financial metrics. A weakening in liquidity or interest cover would also be credit negative.

Key indicators

Exhibit 2

Optivo

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20 (F)
Units under management (no.)	41,903	41,896	42,133	42,857	42,040
Operating margin, before interest (%)	28.0	35.0	30.5	28.5	27.2
Net capital expenditure as % turnover	40.2	9.3	29.2	76.9	70.2
Social housing letting interest coverage (x times)	1.6	1.8	1.8	1.6	1.4
Cash flow volatility interest coverage (x times)	2.0	2.5	1.7	0.4	1.5
Debt to revenues (x times)	3.6	3.1	3.4	4.1	4.5
Debt to assets at cost (%)	45.1	40.1	39.7	43.3	46.1

Optivo's pro forma accounts (2016), Optivo's financial statements (FY2017-19), Optivo's business plan (FY2020).
Source: Moody's Investors Service, Optivo

Detailed credit considerations

On 12 November 2019, Moody's affirmed Optivo's A2 rating and maintained the negative outlook. The affirmation followed Moody's change in the Government of UK's outlook to negative from stable, Aa2 rating affirmed, on 8 November 2019.

Optivo's 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

As of fiscal 2019, 82% of Optivo's revenue comes from its core business of providing social rented housing. The margin derived from social letting is robust, at around 31% in fiscal year ending 31st March 2019, stable at around this level since merger in fiscal 2017. The profitability of the core business is expected to improve over the next few years as the housing association forecasts an additional £5m annual efficiency savings. The profitability of the core business supports Optivo's social housing letting interest coverage, which stood at 1.6x in fiscal 2019, compared to an A2 peer median of 1.5x.

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 fiscal 2019, revenue from sales remained moderate at 9% of total revenue, but this proportion is expected to grow. Despite an increase in lower-margin sales activities and an increased sustainability budget over the next few years, the operating margin is projected to remain relatively stable.

Sufficient liquidity and sound policies

Optivo's level of unencumbered assets is strong, providing additional borrowing capacity of £840 million as of May 2019. The housing association's unencumbered assets cover the additional £692 million of debt that it plans to take on by fiscal 2022. 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 fiscal 2020-2022. As of May 2019, Optivo's liquidity was made up of £67 million in cash and £380 million in undrawn, immediately available facilities. In July and August 2019, Optivo increased their liquidity by adding an additional £120 million in committed bank lines and £25 million in loans.

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.

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 for large and complex HAs. Additionally, 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 will 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.

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 5,000 units are expected to be built over the next five years (equating to 13% of existing stock). While this was the target of the pre-merger business plan, the pace at which Optivo has been able to reach their target has been slower than initially expected, with the first year of over 1,400 units of completions expected to be in fiscal 2023. To accommodate this level of development, net capital expenditure is forecast to average 74% of turnover over fiscal 2020-2022, significantly higher than the average of 38% of turnover for fiscal 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 because the housing association has a larger proportion of their development spend pre-funded, however the shift in tenures towards more affordable housing and shared ownership and fewer outright sales does mean an increase in debt in the business plan as there will be lower cash flows from market sales.

In terms of the tenure mix of the development programme, 54% 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. The development programme also includes a significant component of sales, with around 38% of the total programme dedicated to shared ownership, and the remaining 8% for open market sales.

Sales revenue as a percentage of total, including outright sales and first-tranche shared ownership (FTSO) sales, will increase sharply to 22% in fiscal 2021 (17% FTSO, 5% outright sales) from 9% in fiscal 2019, exposing Optivo to the cyclical housing market. 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 is a credit concern for the HAs developing in these areas[2]. Further amplifying this risk is Optivo's cash flow volatility interest cover (CVIC), which dipped significantly in fiscal 2019, due to a large increase in unsold shared ownership stock held on the balance sheet at fiscal year end. Optivo's CVIC was 0.4x in fiscal 2019, among the lowest of rated housing associations and while it will improve it is expected to be weaker than A2-rated peers going forward, averaging 1.5x over fiscal 2020-2022.

Debt increasing, albeit from a moderate level

In March 2018, Optivo issued a £250 million bond, of which £75 million has still been retained. The proceeds from the issuance were used to repay a variable-rate credit facility, increasing the proportion of Optivo’s fixed-rate debt, and to finance development spending. While Optivo is increasing its exposure to market sales, its most recent business plan shifts focus towards more social rented development and reduces the number of homes built for outright sales; as such, the housing association will need to rely increasingly on more debt to maintain their own target of starting development on 1,500 units per year.

Looking forward, to fund development, Optivo's debt-to-assets at cost ratio will deteriorate to 51% as of the end of fiscal 2022, from 43% as of the end of fiscal 2019. Debt to revenues will also deteriorate over the next three years, reaching 5.1x in fiscal 2022, from 4.1x in fiscal 2019 and a modest level of 3.4x in fiscal 2018. The debt trajectory is a constraint to Optivo's credit profile as debt metrics will be more closely aligned to A3 rated peers.

Optivo's policy is to maintain moderate interest rate risk, which is reflected in the current debt structure. Approximately 80% 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 May 2019, the swap portfolio amounted to a relatively large notional value of £408 million, which had a negative mark-to-market of £148 million with ample property security (£293 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.

Governance considerations are also material to Optivo's credit profile. Optivo's governance and management are strong, underpinned by a broadly stable strategy and solid financial reporting. English housing associations also benefit from a strong regulatory framework and close oversight by the Regulator of 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 a3 is one notch above 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%	42,857	a
Factor 3: Financial Performance			
Operating Margin	5%	28.5%	a
Social Housing Letting Interest Coverage	10%	1.6x	a
Cash-Flow Volatility Interest Coverage	10%	0.4x	b
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.1x	ba
Debt to Assets	10%	43.3%	ba
Liquidity Coverage	10%	0.9x	baa
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**baa1**

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	Negative
Issuer Rating -Dom Curr	A2
OPTIVO FINANCE PLC	
Outlook	Negative
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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