Rating Action: Moody's assigns A3 ratings to Southern Housing and affirms debt ratings of Optivo Finance plc; outlook negative

16 Dec 2022

London, December 16, 2022 -- Moody's Investors Service (Moody's) has assigned an A3 long-term issuer rating and baa2 baseline credit assessment (BCA) to Southern Housing, affirmed the A3 ratings of senior secured debt formerly issued by Southern Housing Group Limited – now in Southern Housing, assigned A3 ratings to senior secured debt formerly issued by Southern Housing Group Limited – now in Southern Housing and affirmed the A3 senior secured debt ratings of Optivo Finance plc. The outlooks are negative. Concurrently, Moody's withdrew the A3 long-term issuer rating, baa1 BCA and negative outlook of Optivo and the A3 long-term issuer and baa2 BCA and negative outlook of Southern Housing Group Limited following their amalgamation into Southern Housing.

Optivo and Southern Housing Group Limited completed their merger on 16 December 2022 and were amalgamated into a new entity, Southern Housing. Southern Housing is now the parent company for Optivo Finance Plc and Optivo and Southern Housing Group Limited's assets and liabilities are now the assets and liabilities of Southern Housing.

A full list of affected ratings can be found at the end of this press release.

RATINGS RATIONALE

The ratings reflect the large size and strong balance sheet of the organisation as well as its projected strong liquidity. The amalgamated entity manages more than 75,000 units, concentrated in South East England. Moody's projects that Southern Housing will have a combined turnover of approximately Â£0.6 billion in FY2023. The rating also incorporates the significant planned development programme and relatively weaker operating margins and interest covers.

The merger creates one of the largest housing associations in England. The large size of the organisation will provide greater influence and will support a higher resilience to financial stresses compared to smaller housing associations. Optivo has a track record of successfully implementing mergers as it was formed out of the merger of Amicus Horizon and Viridian in 2017, as does Southern Housing Group Limited, which recently acquired Crown Simmons. Southern Housing will also benefit from a strong balance sheet with significant housing assets, including unencumbered assets valued at roughly Â£1.8 billion as of August 2022.

The two former organisations held high levels of liquidity and Moody's expects Southern Housing will implement strong liquidity rules. Southern Housing's immediately-available liquidity is projected to be very high at around 2x two-years' forward-looking cash needs at FYE2023. Southern Housing's proposed liquidity policy would also be strong with an 18-month net cash requirement, with all sales income removed and including 12 months of debt amortization.

Southern Housing will continue the significant development programmes of the two former

organisations, which exposes the group to added risks given the weakened operating environment. The new entity plans to develop or acquire around 10,500 units from FY2023 through FY2027, representing roughly 14% of its existing stock. Around a third of the programme will be affordable tenures, a third shared ownership, market sales and market rent, and a third acquisitions. As a result, market sales (including first tranche shared ownership) are projected to reach 20% of turnover in FY2024, a high level. Debt will increase to support this development, although gearing will remain relatively stable and stronger than A3-rated peers.

Southern Housing's operating margin is projected to remain relatively weak over the near term, depressed by higher costs and spending on existing stock combined with a cap on social rent increases of 7% in FY2024. Compared to rated peers, fire and building safety compliance remains a key cost pressure in the medium term. Combined with a projected increase in debt, interest covers will also be relatively weak, with social housing lettings interest coverage averaging around 1.0x over FY2023-25.

The A3 issuer rating incorporates Southern Housing's BCA of baa2 and a two-notch uplift provided by Moody's assessment of a strong likelihood of support from the UK government (Aa3 negative).

Southern Housing's A3 senior secured debt ratings and the A3 senior secured debt ratings for Optivo Finance plc reflect Southern Housing's A3 issuer rating.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlooks reflect Southern Housing's high exposure to weaker economic and financial conditions in the UK. A 7% ceiling on social rent increases in England combined with high cost inflation will weigh on operating margins over the next 12 to 18 months. At the same time, rising interest rates and tightening financing conditions will further weaken interest coverage ratios. A decline in house prices would also affect profitability and surpluses from market sales and further weaken Southern Housing's credit profile.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

A rating upgrade is unlikely in the near term due to the negative outlook. The negative outlook could be stabilised if Southern Housing is able to maintain relatively stable financial metrics over the medium term. This could be driven by operating performance being maintained at current levels, including the ability to contain cost pressures and maintain or improve interest covers.

Southern Housing's rating could be downgraded as a result of one or a combination of the following: a failure to adapt strategies to mitigate against weaker economic conditions; a sustained weakening in operating margins and interest coverage ratios; increases in debt levels beyond that currently anticipated; significant deterioration in liquidity; significant scaling up in market sales exposure or material deterioration in market sales performance greater than currently anticipated; or any weakening of the regulatory framework or dilution of the overall level of support from the UK government. A downgrade of the UK sovereign rating would also place downward pressure on Southern Housing's ratings.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Southern Housing's credit impact score is moderately negative (CIS-3), reflecting moderate exposure to environmental risks, high exposure to social risks along with a low-neutral governance profile, as well as a strong regulatory framework and support from the UK government.

Southern Housing's E issuer profile score is moderately negative (E-3), reflecting moderately negative exposure to environmental risks, primarily due to carbon transition risk from the legislative requirement for English housing associations to improve the energy efficiency of their existing housing stock by 2035, leading to increased expenditure. We consider that Southern Housing has a material exposure to this risk due to a relatively high proportion of its stock requiring retrofit.

Southern Housing's S issuer profile score is highly negative (S-4), reflecting high exposure to risks from responsible production and demographic and societal trends. Responsible production risks include the legislative requirement to improve the safety of its existing housing stock which will increase expenditure over the medium term. This is requiring significant expenditure for Southern Housing. Demographic and societal trends risks reflect the vulnerability of the sector to government policy which controls rent setting in England. The government's recent intervention on social rent policy with a ceiling on social rent increases introduces policy volatility to the sector and will have a negative impact on financial performance.

Southern Housing's G issuer profile score is low-neutral (G-2). Governance in the sector is generally fit for purpose, with good oversight of business risks, strong financial planning and risk management processes and detailed reporting. The regulatory framework also supports good governance in the sector. The newly-formed organisation will have a relatively complex group structure, although some consolidation is expected in the next couple of years.

LIST OF AFFECTED RATINGS

Assignments:

..Issuer: Southern Housing

....LT Issuer Rating, Assigned A3

....Baseline Credit Assessment, Assigned baa2

....Senior Secured Regular Bond/Debenture, Assigned A3

Affirmations:

..Issuer: Southern Housing Group Limited

....Senior Secured Regular Bond/Debenture, Affirmed A3 (Transferred to Southern Housing)

..Issuer: Optivo Finance plc

....Senior Secured Regular Bond/Debenture, Affirmed A3

Withdrawals:

..Issuer: Southern Housing Group Limited

....LT Issuer Rating, Withdrawn , previously rated A3

....Baseline Credit Assessment, Withdrawn , previously rated baa2

..Issuer: Optivo

....LT Issuer Rating, Withdrawn , previously rated A3

....Baseline Credit Assessment, Withdrawn , previously rated baa1

Outlook Actions:

..Issuer: Southern Housing

....Outlook, Assigned Negative

..Issuer: Southern Housing Group Limited

....Outlook, Changed To Rating Withdrawn From Negative

..Issuer: Optivo

....Outlook, Changed To Rating Withdrawn From Negative

..Issuer: Optivo Finance plc

....Outlook, Remains Negative

The methodologies used in these ratings were European Social Housing Providers published in April 2018 and available at https://ratings.moodys.com/api/rmc-documents/64685, and Government-Related Issuers Methodology published in February 2020 and available at https://ratings.moodys.com/api/rmc-documents/64864. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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At least one ESG consideration was material to the credit rating action(s) announced and described above.

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The person who approved Southern Housing and Southern Housing Group Limited credit ratings is Marie Diron, MD-Sovereign Risk, Sub-Sovereign Group, Journalists Tel 44 20 7772 5456, Client Service Tel 44 20 7772 5454. The person who approved Optivo and Optivo Finance plc credit ratings is Mauro Crisafulli, MD-Sub Sovereigns, Sub-Sovereign Group, Journalists Tel 44 20 7772 5456, Client Service Tel 44 20 7772 5454.

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