MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
8 October 2021

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Optivo

Update to credit analysis

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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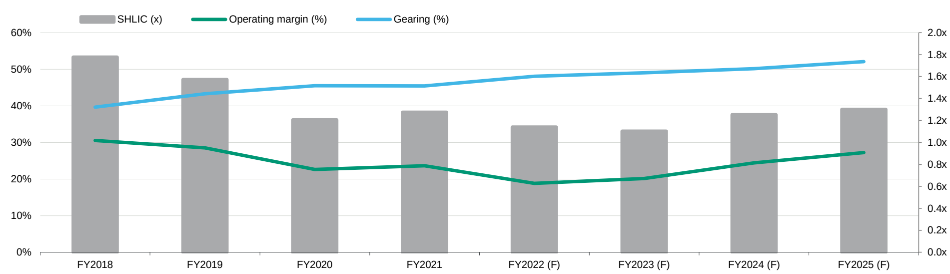
Summary

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 margins and interest coverage and its exposure, though declining, to the cyclical housing market through market sales. The credit profile also incorporates the strong likelihood that the government of the United Kingdom (Aa3 stable) would intervene in the event that the association faced acute liquidity stress.

Exhibit 1
Optivo's operating margins are expected to start recovering from FY2024, whilst gearing will continue to grow as the HA executes its development programme
Social housing lettings interest coverage (x) (RHS), operating margin (%) (LHS), debt-to-assets (%) (LHS)



F: Forecast
Source: Moody's Investors Service, Optivo

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

» Weaker margins and higher debt lowering interest coverage

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

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 supported by strong core social housing lettings business.

Factors that could lead to an upgrade

Upward pressure could result from much slower debt growth; significant improvements in margins and interest cover ratios; and significant decrease in development ambition.

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-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22 (F)	31-Mar-23 (F)
Units under management (no.)	41,896	42,133	42,240	42,568	42,027	43,263	44,880
Operating margin, before interest (%)	35.0	30.5	28.5	22.6	23.6	18.8	20.1
Net capital expenditure as % turnover	9.3	29.2	76.9	57.1	40.3	79.9	57.6
Social housing letting interest coverage (x times)	1.8	1.8	1.6	1.2	1.3	1.1	1.1
Cash flow volatility interest coverage (x times)	2.5	1.7	0.4	1.1	1.4	1.0	1.2
Debt to revenues (x times)	3.1	3.4	4.1	4.6	4.5	4.6	4.6
Debt to assets at cost (%)	40.1	39.7	43.3	45.5	45.4	48.1	49.0

Source: Optivo, Moody's Investors Service

Detailed credit considerations

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 42,000 units under management in fiscal 2021 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 £3.2 billion (at historic cost). As of fiscal 2021, 80% of Optivo's revenue came from its core business of providing social rented housing, the same as in fiscal 2020. Historically, Optivo recorded strong margins on its social letting business, averaging 31% over the period spanning its merger in fiscal 2017 through fiscal 2019. Since fiscal 2020, however, higher fire safety costs and maintenance spending have resulted in lower social lettings margins. Optivo has also had higher void losses in recent years which have also affected its margins. In fiscal 2021, operating margins registered 24%, marginally up from 23% in fiscal 2020.

Optivo has some diversification in rented products, which includes a small portfolio of market and sub-market renting, a modest amount of student accommodation, key worker accommodation and support products; Optivo has now exited the less-profitable specialized care and disposed part of its student housing in Southampton in fiscal 2021. In fiscal 2021, revenue from sales increased to 14%, up from 10% in fiscal 2020, but this proportion is expected to remain modest going forward with sales peaking in fiscal 2023 at 19%.

Despite the pressure of higher fire safety costs, Optivo improved its social lettings margin to 27% in fiscal 2021, from 25% in fiscal 2020. 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 two years, presently projected to average 23% over fiscals 2022-23, before recovering in fiscal 2024 onwards.

Sufficient liquidity and sound policies

Optivo's level of unencumbered assets is strong, providing additional borrowing capacity of £1.4 billion as of July 2021. Optivo has altered its debt pipeline in its current business plan, with net debt peaking later than last year's plan as Covid-19 slowed spending on development sites in 2020 and 2021. Based on Optivo's currently assumed development programme and pipeline through to sites starting in 2026, net debt is now expected to peak around fiscal 2027 at £2.7 billion, compared to just over £2.5 billion in fiscal 2026 in last year's plan. As of July 2021, Optivo's liquidity was made up of £64 million in cash and £640 million in undrawn, immediately available facilities. In May 2020, Optivo 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 £151 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; it will use these funds raised to refinance the CCFF. Additionally, in August 2021 Optivo raised £114 million in proceeds from a sale of its retained portion of its 2035 bonds in order to pay down legacy term loans and to release security.

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. 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. 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.

Weaker margins and higher debt lowering interest coverage

Optivo's margins are expected to weaken over the next two years before starting to recover from fiscal 2024, while its debt will continue to rise to fund its development programme. Optivo is estimating fire safety costs of around £250m over the next ten years which will depress margins compared to historic levels. Interest covers will also remain weaker in the near term. In FY2021, social housing letting interest cover (SHLIC) was 1.3x, up from 1.2x in fiscal 2020 but down from 1.7x over FY2017-19. Going forward, SHLIC is projected to remain around 1.1x over FY2022-24. 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. Additionally, Optivo are expecting to recover a higher amount of these costs from leaseholders in this plan and are aiming to make £6.6 million in efficiency savings over the next three years which will provide further support to margins.

Higher debt will also mean Optivo's debt-to-assets at cost ratio will deteriorate to 50% as of the end of fiscal 2024, from 45% as of the end of fiscal 2021. Debt to revenues will also deteriorate over the next three years, reaching 5.3x in fiscal 2024, from 4.5x in fiscal 2021. 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 FY2027 with current development plans, a year later than in the previous business plan as the impacts of Covid-19 on development sites shifted Optivo's debt profile.

Optivo's policy is to maintain moderate interest rate risk, which is reflected in the current debt structure. Approximately 93% 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 amounted to a relatively large notional value of £477 million, which had a negative mark-to-market of £141 million with ample property security (£286 million) charged to the position to cover any adverse fall in interest rates, as of July 31st 2021,.

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. Optivo's planned level of starts has remained broadly similar to the previous plan, following a scaleback of its development programme in 2020. In its latest 2021 business plan, approximately 6,300 units are expected to be started and 5,200 completed over the next five years (equating to 12% of existing stock). Optivo has deliberately reduced its exposure to outright market sales and shared ownership over the past two years in a strategic movement away from riskier tenures. However, this exposure will still increase over the near term as planned development is completed with market sales peaking at 19% of turnover in FY2023 (up from 14% in FY2020 and 10% over FY2016-19), though this would be predominantly first tranche shared ownership. This exposure is lower than in the previous plan where market sales exposure peaked at 22% in fiscal 2023 and was maintained at a higher level. Whilst moderated, the increase in market sales exposes the group to increased volatility in its operating cash flows which could feed through into Optivo's cash flow volatility interest cover metric.

Net capex is expected to remain elevated over the next five years as Optivo executes its development programme, with net capex averaging 74% of turnover over the next five years. 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 to fiscal 2023 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, 61% 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 31% of completions over this period are planned to be shared ownership (previously 44% in last year's plan) 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 significant committed development currently after fiscal 2023 and it has ensured that all shared ownership development is able to switch tenure if needed.

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 considerations are not material to Optivo's credit profile. In line with the rest of the UK, the sector's main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by country and national authorities, and therefore the financial burden of adapting to increased flood risk will not fall on individual housing associations. Housing associations, however, need to invest in decarbonisation efforts to achieve government targets. Optivo has included achieving EPC C for all its properties by 2030 in its business plan.

Social risks are material to Optivo's credit profile. In particular, the sector is exposed to risks stemming from socially-driven policy agendas affecting social rents, benefits and capital grants in addition to the impact of demographic trends on demand which are captured in our assessment of the operating environment. We view the coronavirus outbreak as a social risk under our ESG framework given its impact on health and safety. Overall, we expect the outbreak to cause ongoing operational disruption for HAs but do not expect a material credit impact as higher arrears and lower market sales receipts will be offset by cash savings from reduced capital spending on development and repairs. HAs are also affected by customer relations and product quality. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards with many HAs planning on increasing spending on the quality of their existing stock.

Governance considerations are also material to HAs' credit profiles and are captured in our assessment of governance and management. In general, housing association governance is strong with multi-year strategies supported by detailed forecasts, conservative liquidity policies, and robust risk management including stress testing.

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's 2021 Scorecard

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%	42,027	a
Factor 3: Financial Performance			
Operating Margin	5%	23.6%	baa
Social Housing Letting Interest Coverage	10%	1.3x	baa
Cash-Flow Volatility Interest Coverage	10%	1.4x	baa
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.5x	ba
Debt to Assets	10%	45.4%	ba
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			**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 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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