

CREDIT OPINION

22 December 2016

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RATINGS

Clarion Housing Group Limited

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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Clarion Housing Group Limited

Update to Key Credit Factors

Summary Rating Rationale

The A2 issuer rating assigned to Clarion Housing Group Limited (CLH) reflects its: large size and sizeable balance sheet; strong though slightly declining operating margins; good liquidity supported by strong unencumbered assets and robust treasury policy; increasing exposure to market sales; increasing debt and weakening social letting interest cover; and merger implementation risks.

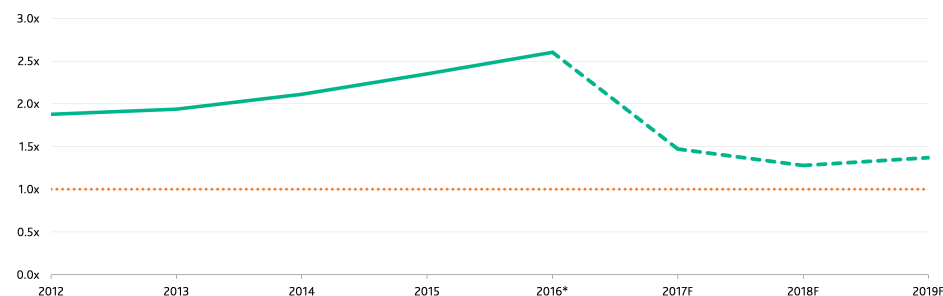
The A2 rating also benefits from the strong regulatory framework governing English housing associations and our assessment that there is a strong likelihood that the UK government (Aa1 negative) would intervene in the event that CLH faced acute liquidity stress.

CLH is rated in the middle of the range of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. CLH's relative position reflects its historically strong and stable margins and high interest coverage ratios, higher flexibility due to considerable amount of liquidity and unencumbered assets, but also rising sales and development exposure and merger implementation risks.

On 29 November 2016, Clarion Housing Group Limited was officially formed following the merger of Affinity Sutton Group Limited and Circle Housing Group with the transfer of engagements of Circle Anglia Limited (the parent company of Circle Housing Group) to Affinity Sutton Group Limited. Affinity Sutton Group Limited was renamed Clarion Housing Group Ltd.

Exhibit 1

Social housing letting interest cover is projected to decline



*FY2016 represents ASG's standalone performance, restated for FRS 102. The FY2017-2019 forecast shows the expected performance of Clarion Housing Group.
Source: Clarion Housing Group, Moody's

Credit Strengths

Credit strengths for CLH include:

- » One of the largest housing associations in the UK with sizeable balance sheet
- » Strong operating margins but expected to decline slightly
- » Good liquidity position supported by strong unencumbered assets and robust treasury policy
- » Strong regulatory framework

Credit Challenges

Credit challenges for CLH include:

- » Increasing debt and weakening social housing letting interest cover
- » Merger implementation challenges and increased complexity of group structure
- » Increasing exposure to market sales which adds complexity to operations and increases cash flow volatility
- » Government policy changes make operating environment less predictable and more challenging for housing associations

Rating Outlook

The outlook on CLH's rating is negative reflecting the sector wide risks on the housing association (HA) sector following the UK vote to leave the European Union (EU). Pressures on public finances stemming from weaker GDP growth could result in further policies restricting HA revenues. Additionally, volatility and/or slower house price growth could negatively impact CLH, as it increases its exposure to market sales.

Factors that Could Lead to an Upgrade

One or a combination of the following could have positive rating implications:

- » operating margins remaining strong at comfortably over 35%
- » social housing letting interest cover comfortably sustained above 1.5x
- » debt structurally falling below 40% of assets at cost

Factors that Could Lead to a Downgrade

Negative pressure could be exerted on the rating by one or a combination of the following:

- » underperformance of its development-for-sale schemes resulting in a deterioration in CLH's currently strong liquidity position
- » significant weakening in its operating margin from core activities
- » failure to implement the long term efficiency programmes with margins lower than anticipated and/or failure to address Circle's existing London repair and maintenance backlog
- » a deterioration of its social housing letting interest cover below projections and a resulting weaker shock absorption capacity
- » a weaker regulatory framework, a dilution of the overall level of support from the UK government or a downgrade of the UK sovereign rating.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 2

Clarion Housing Group	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17F	31-Mar-18F
Units under management (no.)	56,107	56,467	56,856	57,794	58,808	124,259	123,632
Operating margin, before interest (%)	33	35	38	38	36	33	31
Net capital expenditure as % turnover	37.9	22.4	38.1	-2.9	-3.8	56.1	69.7
Social housing letting interest coverage (x times)	1.9	1.9	2.1	2.3	2.6	1.5	1.3
Cash flow volatility interest cover (x times)	2.1	2.0	2.0	2.8	2.9	1.1	0.8
Debt to revenues (x times)	4.3	4.0	4.1	2.8	2.4	4.3	4.5
Debt to assets at cost (%)	45	45	45	43	41	47	47

FY2016 calculated using ASG's FRS 102 compliant accounts. FY2017-18F based on Clarion Housing Group.

Source: Clarion Housing Group, Moody's

Recent Developments

On 29 November 2016, Clarion Housing Group Limited was officially formed following the merger of Affinity Sutton Group Limited and Circle Housing Group with the transfer of engagements of Circle Anglia Limited (the parent company of Circle Housing Group) to Affinity Sutton Group Limited. Affinity Sutton Group Limited was renamed Clarion Housing Group Limited. Affinity Sutton Group and Circle Housing Group were similar in size and on merger, Clarion became one of the largest housing associations in England with around 125,000 units under management.

Detailed Rating Considerations

CLH's rating combines (1) its baseline credit assessment (BCA) of baa1, and (2) a strong likelihood of extraordinary support coming from the UK government in the event that CLH faced acute liquidity stress.

Baseline Credit Assessment

ONE OF THE LARGEST HOUSING ASSOCIATIONS IN ENGLAND WITH SIZEABLE BALANCE SHEET AND POTENTIAL FOR EFFICIENCIES

Clarion is a large provider of social housing in England with 123,036 units under management. Operations are spread nationwide across almost 150 local authorities, where demand for social housing is generally high. At FYE2016, Affinity Sutton Group (ASG) and Circle's (CIR) combined housing assets net of capital grants were GBP3.5 billion; this is projected to increase to GBP6.2 billion at FYE2020. This provides CLH with a sizeable balance sheet with an increased capacity to deal with uncertainties, providing greater resilience to financial stresses.

Larger organisations also tend to have higher expenditure flexibility with room to increase operating efficiency, and the ability to take advantage of economies of scale during economically challenging times. Clarion has a history of successful mergers with smaller entities (as Affinity Sutton). In 2003, The Affinity Homes merged with Downland Housing Group and in 2006, Affinity merged and successfully integrated with another large housing provider, William Sutton forming Affinity Sutton. The merger of ASG and CIR has the potential to bring about efficiencies. Scale could bring procurement savings and efficiencies in management costs. CLH's management team has a strong track record in driving efficiencies and delivering on the company's plans and these efficiencies have contributed to CLH's high operating margins in recent years. Moreover, CIR's operating costs per unit was higher than ASG's; there is the potential for the combined entity's costs to move more in line with ASG's former cost per unit.

STRONG OPERATING MARGINS BUT EXPECTED TO DECLINE SLIGHTLY

CLH's operating margin was 36% in FY2016 and averaged 36% of turnover over the last five years, well above the 27% average of its rated peers over the same period. The strong margins were primarily due to efficient cost control measures, realised economies of scale and solid and improving rent collection rates. Operating margins following the merger are projected to remain robust but record slightly lower levels, averaging 32% over FY2017-21. Total margins are also expected to increase and average 33% over FY2017-21

(from ASG and CIR combined's 22% in FY2016), though this incorporates the expectation of selling 5,000 social housing units to other housing associations over FY2018-21. If these units were not sold as planned, this would also affect cash flow projections.

With the government announced rent cut, Affinity Sutton had previously expected that the annual shortfall in social housing rental income compared to the pre-announcement position would be around GBP38 million, while Circle had expected rental income to be GBP 50 million less. The board approved business plan for Clarion incorporates the effect of the rent reduction and mitigation measures that CLH is implementing.

GOOD LIQUIDITY POSITION SUPPORTED BY STRONG UNENCUMBERED ASSETS AND ROBUST TREASURY POLICY

CLH enjoys a good liquidity position, supported by strong unencumbered assets. Immediately available liquidity, represented by cash and readily available undrawn facilities, was GBP1.1 billion at October 2016, which is equivalent to roughly 115% of revenues, which is above the latest median of Moody's rated peers (91%). Its current immediate liquidity enables CLH to fund 1x its two-year net capital requirements of GBP1.1 billion, indicating healthy liquidity and no immediate reliance on additional funding to realise their immediate aspirational development programme. As security for its debt, CLH has utilised a security pool charging 62,000 units valued at GBP4.7 billion (GBP2.95 million at Existing Use Value for Social Housing and GBP1.75 million at Market Value subject to Tenancy). Unencumbered assets, valued at almost GBP748 million at EUV-SH and a further GBP114 million at MVT as at October 2016, could provide additional borrowing capacity of around GBP812 million.

Favourably, CLH's management places an importance on liquidity. The current policy is to hold the greater of £150m in cash, or a sum equal to the next 3 months gross development spend (November 16: £100m). Operating cash held at November 16 month end was £222.2m. Furthermore, CLH's draft liquidity policy states that the current policy is to hold sufficient liquidity to cover requirements for the next 18 months including scheduled debt repayments, reducing sales income and excluding land banking. We view this as a strong policy and as a credit positive.

Management's commitment to the financial strength of the organisation is demonstrated by the creation of financial Golden Rules, similar to those the former ASG had on a standalone basis for more than ten years. The rules would include for the Group: (i) interest cover (Earnings before interest, taxes, depreciation, amortisation over net interest paid) over 1.5x; (ii) maintaining an operating margin above 30%; (iii) limiting debt growth to 4x revenue (4.5x in FY2018); and (iv) keeping sales exposure under 40% of turnover (excluding regeneration). We expect that management will seek to keep in line with these rules as it has done in the past and adjust plans as needed to do so.

STRONG REGULATORY FRAMEWORK

English housing associations operate in a highly regulated environment, with a strong oversight exercised by the sector's regulator, the Homes and Communities Agency (HCA). The regulator is responsible for protecting the public investment in social housing and compliance with broad economic and consumer standards. Compliance with the standards is proactively monitored by the HCA

through quarterly returns, long term business plan and annual reviews, and focuses on: governance, financial viability, value for money and rents.

The HCA's levers of control are wide ranging and include awarding capital grant funding, consent to dispose of or use assets to secure debt, levy financial penalties, and impose independent inquiries or appoint new managers and officers in extreme circumstances.

The HCA emphasises that their role is a co-regulatory one with the primary onus being on boards and executive teams to ensure compliance with the standards. We expect that the rapidly changing environment will put increased pressure on the regulator.

INCREASING DEBT AND WEAKENING SOCIAL HOUSING LETTING INTEREST COVER

CLH's social-housing-letting interest-coverage ratio (including depreciation, SHLIC), a measure of the organisation's ability to cover interest costs from low-risk activities, was 2.6x in FY2016; among the highest within the Moody's rated peers (FY2015 median: 1.3x). We note, however, that CLH's coverage ratios have benefitted more strongly from the current low-interest-rate environment than those of rated peers as the association held a quarter of its debt at variable rates, above the latest median of its rated peers of 17%. CLH's debt slightly declined to GBP1.2 billion at FYE2016 from 1.3 billion at FYE2015; this debt at FYE2016 was equivalent to around

2.4x revenues and 41% of assets at cost (gearing), which was below rated peers' respective medians of 3.9x and 48% at FYE2015. While CIR's debt-to-revenue fell to 4.5x at FYE2016 (FYE2015: 4.8x) as a result of increased turnover from non-social housing activity, debt-to-revenue remained above the median of the A2 peer group. In addition, CIR recorded relatively low social housing interest cover in FY2016 at 1.0x. With the merger, CLH's combined debt was GBP3.3 billion at FYE2016, equivalent to around 3.5x revenues and 49% of assets at cost, in line with A2 peers.

Under the board-approved business plans for Clarion, however, these credit metrics will weaken. To fund its ambitious development programme over the next five years, CLH's debt will increase to GBP4.4 billion by FYE2020 and GBP4.8 billion by FYE2021. As a result, debt to revenues and gearing will increase and peak in FY2018 at 4.5x and 47%, respectively. As debt increases, SHLIC will fall and average 1.3x over FY2017-21. These metrics would be broadly in line with A2 peers.

INCREASING EXPOSURE TO MARKET SALES WHICH ADDS COMPLEXITY TO OPERATIONS AND WILL INCREASE CASH FLOW VOLATILITY

The merger transformation and change in strategy will lead to increased market sales. As a result, social housing letting as a percentage of turnover will fall. However, operating margins are projected to remain robust, averaging 32% over FY2017-21 assuming merger savings are achieved and total margins are also expected to be high and average 33% over FY017-21, though it also incorporates the expectation of selling 5,000 social housing units to other housing associations over FY2018-21.

The business plans indicate that market sales activity will increase significantly and remain substantial relative to peers. Sales revenue is projected to account for 37% of turnover in FY2020. As a result, the relatively lower-risk social housing letting income will decline markedly relative to turnover. We note that high exposure to sales has a potential to add volatility to CLH cash flows and complexity to its operations. Moreover, HAs with larger development programmes are more susceptible to development risks, which can include: speculative building and buying, landbanking strategies, unexpected increases in build costs and/or labour shortages and unpredictable revenues from market sales activity.

Balanced against these risks is CLH's experience in delivering development projects, though we note that the scale will be ramped up with a required increase in capacity. CLH also have a number of mitigants against these development risks, including: that all contracted development would be covered by cash or immediately available facilities; the bulk of sales projected for FY2017-21 are aspirational and still to-be-committed, with CLH having the ability to scale them down if market conditions deteriorate; the ability to change tenure from private sale to private rent (though this would affect cash flows); and that there is no reliance on sales to cover interest costs.

MERGER IMPLEMENTATION CHALLENGES AND INCREASED COMPLEXITY OF GROUP STRUCTURE

Despite CLH's history of mergers, there are challenges with execution and integration of the two large entities and there is transition risk as the organisation transforms. Furthermore, ASG and CIR already had separate significant efficiency plans in train, with ASG having planned to deliver GBP12 million in savings by FY2020 and CIR GBP46 million by FY2019, on top of the GBP38 million merger savings anticipated, of which GBP10 million is capital. As such, there is a risk that the savings and synergies anticipated will not be fully realised or be realised less quickly than anticipate. While efficiencies may eventually be realised, the restructuring and escalation of the entity's development programme over the near to medium term, alongside implementing the savings plans, restructuring and integration of the two entities considerably increases the execution risks associated with a merger of this size.

Coming into the merger, CIR had a complex group structure and in parallel to the merger, CLH is also restructuring CIR's registered providers. Previously, CIR had 16 main trading entities in the Circle group of which 10 were registered providers. This group structure adds complexity to governance and management. The parent of Circle, Circle Anglia Limited, which was one of the 10 registered providers, had effective control over all subsidiaries by board appointment. CIR is presently undergoing restructuring to collapse the nine registered asset holding subsidiaries into one registered provider (RP), leaving two registered providers at the end of the restructuring. The amalgamation will continue through merger and should be completed by Q2 2017. At merger, three Circle subsidiaries had collapsed into Circle 33, with six Circle RPs at merger. Eventually, post-merger, all the Clarion RPs will be consolidated into a single RP under the Group parent.

The corporate structure of CLH also differs significantly from the previous structure of ASG. In particular, there is a separation of the core social housing landlord business and the creation of a commercial arm (Latimer) designed to generate profits to be distributed to the RP Group.

Clarion's new corporate structure comprises the Group parent, Clarion Housing Group, which is a non-asset owning housing association with charity status and two business subsidiaries: the HA subsidiary, which holds the core social housing landlord business, and a new commercial arm, Latimer. Latimer contains activities related to private market rent, development for sale, care and support activities and other market services. In addition, under the Group parent, there is a charitable subsidiary and the funding vehicles. The aim of Latimer is to generate profits that would be distributed to the HA subsidiary to cross-subsidise the construction of new affordable homes. Latimer will initially be funded through equity or subordinated debt from the HAs with the expectation to eventually fund Latimer through 40% equity/subordinated debt from the HAs and 60% external debt on a non-recourse basis. Nevertheless, the investment in the commercial arm from the HAs will be significant with an initial investment of GBP156 million in FY2017 and a plan to reach almost GBP1 billion in FY2027, and we consider the group as a whole.

In April 2015, CIR's Governance rating was downgraded to G3 from G1 by the HCA. This resulted from notable under-performance of their responsive repairs and maintenance service in two of CIR's then nine RP subsidiaries: Old Ford Housing Association and Circle 33 Housing Trust. CIR reallocated GBP8.4 million in spending over 2015 and 2016 to address the problem and CLH have also injected additional resources. In June 2016, the HCA raised CIR's governance rating to G2 citing improved governance arrangements. Following the merger, the HCA issued an interim judgement for Clarion of G2 governance rating and V1 viability rating, reflecting Circle's most recent grading.

GOVERNMENT POLICY CHANGES MAKE OPERATING ENVIRONMENT LESS PREDICTABLE AND MORE CHALLENGING FOR HOUSING ASSOCIATIONS

The operating environment for social housing providers is fundamentally shaped by government policy and recent budget announcements have made these circumstances more challenging. On 8 July 2015, the UK government announced (1) a change in the social housing rent formula to 1% annual reduction starting from April 2016 for 4 years (previously growth annually by CPI+1%) and (2) further reductions in the accessibility of certain welfare benefits. The effect of these measures is further magnified by the ongoing implementation of Universal Credit and the likely extension of Right to Buy for HA tenants. Overall, these policy shifts are gradually eroding the credit positive ties to the government by creating a more unpredictable operating environment and undermining the extent and stability of housing benefit's contribution to revenues.

Our preliminary assessment indicated that the change in the rent formula will result in an average annual loss in total turnover of 7% for our rated portfolio over the four years starting FY2017. It is also likely to cause a decline in a currently high proportion of housing associations' turnover coming from social housing rents (average of 73% in FY2015).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 25% of CLH's total income, compared to the latest average of 29% for Moody's-rated peers. CLH have put in place a range of mitigating measures to respond to Welfare Reform, including proactive management of rent arrears, support for tenants and promotion of direct debit payments. The possible extension of the Right to Buy to housing association tenants may in short-term lead to positive cash inflows in the short-term, but creates a risk of a longer term erosion of social housing stock. We do not expect CLH to be significantly impacted by the extension of Right to Buy.

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 (Aa1 negative) is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support also factors housing associations' increasing exposure to non-core social housing activities, that add complexity to their operations and make an extraordinary intervention more challenging.

In addition, our assessment that there is a very high default dependence between CLH and the UK government reflects their strong financial and operational linkages.

Rating Methodology

[European Social Housing Providers](#), July 2016 (190944)

[Government Related Issuers](#), October 2014 (173845)

Ratings

Exhibit 3

Category	Moody's Rating
CLARION HOUSING GROUP LIMITED	
Outlook	Negative
Issuer Rating -Dom Curr	A2
CIRCLE ANGLIA SOCIAL HOUSING PLC	
Outlook	Negative
Senior Secured -Dom Curr	A2
AFFINITY SUTTON CAPITAL MARKETS PLC	
Outlook	Negative
Senior Secured -Dom Curr	A2
CIRCLE ANGLIA SOCIAL HOUSING 2 PLC	
Outlook	Negative
Senior Secured -Dom Curr	A2

Source: Moody's Investors Service

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