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CREDIT OPINION
29 September 2017

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RATINGS

Notting Hill Housing Group

Domicile	United Kingdom
Long Term Rating	A3
Type	LT Issuer Rating - Fgn 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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Notting Hill Housing Group

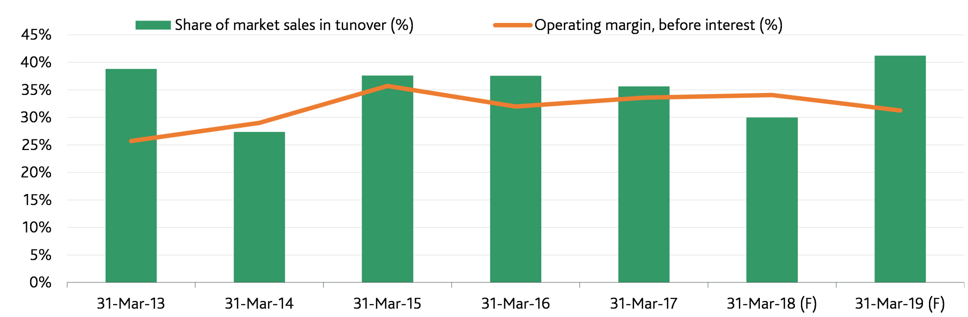
Update following downgrade to A3, outlook changed to stable

Summary Rating Rationale

The credit profile of Notting Hill Housing Group (Notting Hill) reflects its improved operating performance driven by reduced costs on its core business as well as its highly profitable market sales activity based in areas of high demand in London. Notting Hill also benefits from a relatively low level of indebtedness compared to peers, which will remain strong despite a forecasted increase in debt over the next three years. All English housing associations' profiles benefit from the strong regulatory framework governing English housing associations.

Notting Hill is embarking on an ambitious growth strategy which will weigh on key metrics over the next three years. The association's debt will grow to £2.1 billion by FY2020 from £1.3 billion in FY2017 putting pressure on debt an interest cover ratios. In addition, Notting Hill will retain a high (>20% of turnover) exposure to market sales activity which will result in volatile operating cash flows and expose the organisation to macroeconomic risks associated with build cost and house price inflation.

Exhibit 1
Notting Hill's profitability will remain strong, supported by market sales activity
Operating margin and share of market sales in turnover, FY2013-FY2019



Source: Moody's, Notting Hill Group financial statements and forecast

Credit Strengths

» Improved operating performance driven by lower costs on its core business and strong performance on its market sales activity

» Relatively low level of indebtedness, although expected to increase to fund development

» Strong regulatory framework

Credit Challenges

- » Sustained high exposure to market sales revenues affecting predictability of cash flows and exposing the organisation to macroeconomic risks
- » Weak cash flow volatility interest cover due to volatile operating cash flows
- » Increase in debt to £2.1 billion from £1.3 billion over next three years
- » Breach of treasury policy resulting in lower financial management score, albeit sufficient liquidity
- » Operating environment remains challenging but policy is more stable

Rating Outlook

The stable outlook on Notting Hill's rating reflects the currently stable policy environment, which is unlikely to undergo material change in the medium term. The stable outlook also reflects the stable outlook on the sovereign rating, reflecting the close institutional, operational and financial linkages between the central government and housing associations.

Factors that Could Lead to an Upgrade

Positive pressure on the rating could result from a combination of the following: (1) operating margin maintained above 30% revenues; (2) improved profitability of the core social housing business resulting in sustained social housing letting interest coverage above 1.3x; (3) a significant reduction in its market sales activity to levels sustained below 30% of turnover; (4) greater stability in operating cash flows resulting in cash flow volatility interest cover which consistently exceeds 2.0x; and (5) strengthened financial management with strict adherence to its treasury policy.

Factors that Could Lead to a Downgrade

Downward ratings pressure would be exerted by further deterioration of the UK sovereign's creditworthiness. Additionally, whilst unlikely in the near term, negative pressure could be exerted on the rating by one or a combination of the following: (1) lower than projected sales volumes and/or profits; (2) a further scaling up of its already high market sales exposure, (3) a weakening of social housing letting interest cover to levels below 1.0x; and/or (4) a weakening of its historically strong liquidity position. In addition, a weaker regulatory framework, a dilution of the overall level of support from the UK government would also exert downward pressure on the rating.

Recent Developments

On 26 September 2017, Notting HIll's rating was downgraded to A3 from A2 to reflect the close institutional, operational and financial linkages between the central government and UK housing associations (HAs), and the reduced financial resilience of the sovereign as captured by Moody's downgrade of the UK's sovereign rating to Aa2 stable from Aa1 negative. The outlook has been changed to stable from negative to reflect the stable outlook on the sovereign rating, and the HA sector adapting well to a challenging policy environment, which is not expected to undergo further material change in the medium term.

In addition, Moody's lowered the bca for Notting Hill to baa2 from baa1 reflecting a weakened financial management score driven by a lack of adherence to its treasury policy sustained for several months. While Moody's expects the policy breach to be resolved in the coming months, given the association's profile as a significant developer with a sustained high (>20% of turnover) exposure to market sales activity, a lack of adherence to its policy negatively impacts its credit profile.

In July 2017, Notting Hill's board approved a merger with Genesis Housing Association (Genesis, Baa1, negative outlook) to form a new group, NottingHill Genesis, by the end of the calendar year. The two organisations share a similar geography and an ambitious growth strategy, but Genesis's credit profile is weaker due to its low interest cover ratios, high level of indebtedness, and forecasted increase in debt and capital expenditure. We will formally assess the credit implications closer to the merger date, once a board-approved business plan is in place.

Key Indicators

Exhibit 2

	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18 (F)	31-Mar-19 (F)
Units under management (no.)	27,170	28,418	29,573	30,679	32,079	33,479	33,479
Operating margin, before interest (%)	25.7	29.0	35.7	32.0	33.6	34.1	31.3
Housing assets (GBP million)	1,098.2	1,226.5	2,940.4	3,034.3	3,149.7	3,331.2	3,538.7
Net capital expenditure as % turnover	-1.3	87.5	34.4	32.4	35.2	103.2	65.5
Social housing letting interest coverage (x times)	1.4	1.0	1.0	1.2	1.3	1.3	1.1
Cash flow volatility interest coverage (x times)	2.4	-0.4	1.5	1.2	2.2	0.0	0.5
Debt to revenues (x times)	2.9	4.0	3.1	3.2	3.3	4.7	4.1
Debt to assets at cost (%)	36.7	39.3	45.5	43.4	42.1	44.7	47.5

Source: Moody's, Notting Hill Group financial statements and forecast

Detailed Rating Considerations

Notting Hill's rating combines (1) a baseline credit assessment (BCA) for the entity of baa2, and (2) a strong likelihood of extraordinary support coming from the UK government in the event that the entity faced acute liquidity distress.

Sustained high level of market sales will cause volatility in operating cash flows and expose the organisation to macroeconomic risks

Notting Hill's exposure to market sales will remain among the highest of Moody's-rated housing associations subjecting the association to volatile cash flows. Although the core social housing lettings business is subject to political risk (see below Government policy changes make operating environment less predictable and more challenging for housing associations), over the long term, revenue from social housing lettings is more predictable and less risky than revenue generated from property sales. Notting Hill's percentage of revenue from social housing lettings at 56% in FY2017 is far below the A3-rated FY2016 peer median of 80% and constrains its credit quality.

We expect a sustained high exposure (>20% of turnover) to market sales over the next three years. On average, market sales will constitute 42% of total turnover for Notting Hill over the next three years, but the percentage will range from 30% in FY2018 to 55% in FY2020. The variation is due to the nature of its development programme, which has several large, phased development schemes. Expectations for margins on market sales are attainable given location and past performance, averaging 24% over the next three years compared to FY2017 performance of 34%.

The substantial amount of market sales activity exposes the organisation to macroeconomic fluctuations, particularly around build cost and house prices. Notting Hill failed to meet its KPI in FY2017 for build cost per square unit, which was £2,709 compared to a target of £2,176 primarily due to higher inflation. In addition, house prices in London have cooled and are growing at a slower rate than the national average. To the year June 2017, house prices in London increased by 2.9% compared to 4.9% for the UK as whole, according to the latest report from the Office for National Statistics. We will continue to monitor performance on market sales activity.

Debt will increase to fund ambitious development programme

Notting Hill's development programme is ambitious for its size. Borrowing will increase over the next three years to fund ambitious growth targets and capital expenditure (capex) will be high relative to historical levels. The association's current strategic plan includes a higher annual completion target of 1,600 new homes will be built per year compared to the previous target of 1,400 units. Although the target number of homes built has increased, the development programme has been rebalanced in terms of tenure towards rented social housing. Rented social housing and shared ownership will account for 31% each of total units built, with outright sales and market rent accounting for 19% each of the total units.

The ambitious development programme is reflected in the high net capex to revenues will average 60% over the next three years, compared to an A3-rated FY2016 peer median of 17%. The development programme is the primary driver behind Notting Hill's substantial debt growth over the next three years, which is expected to reach reaching £2.1 billion by FY2020 compared to £1.3 billion in FY2017. Although development plans are ambitious, Notting Hill will retain some flexibility in its capital plans, as only 42% of capex in the business plan is committed (as of August 2017).

Despite the increase in debt, Notting Hill will retain its strong balance sheet, with gearing (debt to assets at cost) lower than that of its A3-rated peers, a credit strength. At FYE2017, Notting Hill's debt was £1.3 billion, equivalent to 3.3x revenues and 42% of assets at cost compared to A3-rated peer medians for debt to revenues and gearing of 3.8x and 56% respectively in FY2016.

Debt metrics will weaken as debt increases. Debt to revenues will average 4.0x over the next three years, broadly in line with A3-rated peer medians. Gearing will increase slightly to levels between 45% and 50% over the next three years which will be a weakening relative to historical levels for Notting Hill but remain strong for the peer group.

Breach of treasury policy resulting in lower financial management score, albeit sufficient liquidity

In September 2017, Moody's lowered the BCA of Notting Hill by one notch to baa2 from baa1 reflecting a weakened financial management score, driven by a lack of adherence to its treasury policy sustained for several months.

Notting Hill's treasury policy, revised in March 2016, calls for sufficient liquidity to cover all committed development, or, if higher due to aspirational development, 18 months' projected cash flow. Primarily due to a combination of funding not materialising as planned and deferring of funding due to its merger discussions with Genesis Housing Association, the second of these requirement dropped to 11 months and was sustained below the 18-month requirement for several months, although the association maintained sufficient liquidity to cover committed development at all times.

While Moody's expects the policy breach to be resolved when funding is secured in Q4 2017, given the association's profile as a significant developer with a sustained high exposure to market sales activity, a lack of adherence to the policy negatively impacts its credit profile. Once funding is obtained, Notting Hill's liquidity coverage ratio is expected to recover to 1.3x in line with a rated peer median of 1.4x.

Notting Hill does have mark-to-market exposure from its standalone swap portfolio, but has ample unencumbered assets which it can post as collateral in the event of adverse movement. At the end of June 2017, swap contracts had a negative mark-to-market value net of thresholds of £35 million. In cases where Notting Hill has exceeded the threshold amount, property has been posted. Moreover, ample unencumbered assets (estimated at £1.7 billion in July 2017) ensures further margin calls can be properly met.

Very weak cash flow volatility interest cover ratio over the next couple years, stable social housing lettings interest cover

Notting Hill's cash flow volatility interest cover (CVIC) ratio is expected to weaken significantly over the next two years, reflecting the volatility in its operating cash flows as a result of its high exposure to market sales. Notting Hill's CVIC was 2.2x in FY2017, above the A3-rated peer median in FY2016 of 1.8x. However, the CVIC is expected to drop to a very low 0.02x in FY2018 and remain low at 0.5x in FY2019. The drop reflects the volatile operating cash flows, which will range from £55 million in FY2018 as Notting Hill invests in new stock for sale, to £305 million in FY2020 as market sales receipts are realised.

Notting Hill's ability to cover its interest expense from the core social housing business, as measured by the social housing lettings interest cover ratio, has improved in recent years to levels in line with peers but is expected to weaken slightly going forward under pressure from higher interest expense. The ratio improved to 1.3x in FY2017, up from 1.0x in FY2015 but and is currently aligned to the A3-rated peer median for FY2016 of 1.3x. Over the next three years, growth in interest expense will outpace growth in surpluses from the core business and exert downward pressure on the ratio, which is expected to weaken to 1.1x by FY2019.

Solid operating margin driven by improved profitability in core business

Notting Hill's profitability has improved over the last five years and is expected to be sustained at levels above 30% over the next three years. The operating margin improved slightly in FY2017 to 34% compared to an A3-rated peer median of 32% driven by improved profitability on the core social housing landlord business.

Notting Hill's operating margin on the core social housing business of 36% was a continuation of a multi-year trend of improved performance on the core business. Notting Hill's management are proactively addressing their relatively higher cost base and have delivered savings in the last financial year particularly around repairs and maintenance cost per unit, which has decreased to £1,781 in FY2017 from £2,002 in FY2015. We expect profitability on the core business to remain strong around 34% over the next three years.

Strong regulatory framework

The sector's credit quality will continue to benefit from the strong regulatory framework and oversight by the Homes and Communities Agency (HCA). The HCA maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and undertaking In-Depth Assessments of entities where deemed necessary. Additionally, the HCA has powers to make board member and manager appointments where there has been a breach of Regulatory Standards. From October 2017, the HCA will charge fees for social housing regulation, as a means of enhancing the independence and maintaining the effectiveness of the regulator.

Operating environment remains challenging but policy is more stable

Moody's does not expect additional material adverse policy shifts for the sector and considers the operating environment to be stable in the medium term. Adverse policies announced in the last few years will continue to negatively impact revenues, especially the effects of 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 to mitigate the impact. A reduction of capital grant for new social housing over the last five years has led to increased exposure to market sales activity, which has more than doubled since 2012 to reach 17% of turnover for Moody's rated HAs in FY2016. Credit risk associated with exposure to market sales is incorporated in BCAs.

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 (Aa2 stable) 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 (HA) and the UK government reflects their strong financial and operational linkages.

Rating Methodology and Scorecard Factors

European Social Housing Providers, July 2016 (190944)

Government-Related Issuers, August 2017 (1047378)

Ratings

Exhibit 3

Category	Moody's Rating
NOTTING HILL HOUSING GROUP	
Outlook	Stable
Issuer Rating	A3
PARENT: NOTTING HILL HOUSING TRUST	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

REPORT NUMBER 1091647

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