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PUBLIC SECTOR EUROPE

CREDIT OPINION
13 June 2018

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RATINGS

Orbit 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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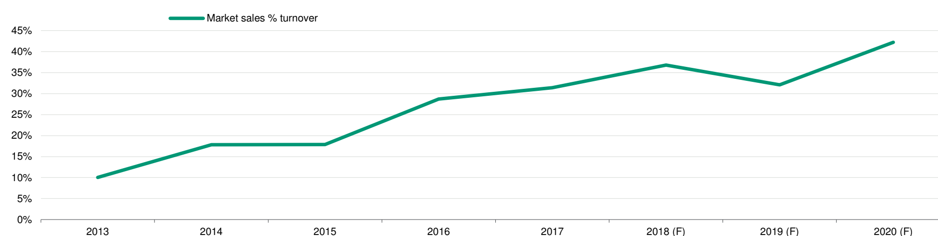
Orbit Group Limited

Update following change in outlook to negative and rating affirmation

Summary

The credit profile of Orbit Group Limited (A2, Negative) ("Orbit") reflects its strong interest coverage ratios, sizeable unencumbered asset position, established market position, and the group's straightforward governance structure. Counterbalancing the strengths of Orbit are an increasing proportion of revenue reliant on market sales, large exposure to standalone swaps, and liquidity coverage levels below A2 rated peers. Orbit benefits from the strong regulatory framework governing English housing associations and our assessment that there is a strong likelihood that the UK government (Aa2 stable) would intervene in the event that Orbit faced acute liquidity stress.

Exhibit 1
Orbit's reliance on sales receipts continues to increase, and is planned to exceed 40% of turnover by FY2020
Market sales as % turnover, FY2013-FY2020(F)



Source: Orbit and Moody's Investors Service

Credit strengths

» Continued strong interest coverage metrics

» Debt metrics in-line with peers and relatively stable, despite planned borrowing increase

» Sizeable pool of unencumbered assets

Credit challenges

» Ambitious development plan increasing capital expenditure and market sale exposure

» Weaker operating margin driven by lower margin sales activity

» Exposure to capital market volatility as a result of large standalone swap portfolio

Rating outlook

The negative outlook on Orbit reflects the credit risk stemming from the group's plans to materially increase capital expenditure, as well as the increased exposure to market sales in the group's development plans.

Factors that could lead to an upgrade

While an upgrade is unlikely, the outlook could return to stable from one or a combination of the following: (1) a pulling back in planned capital expenditure, leading to an improved liquidity coverage metric, (2) a reduced risk profile as evidenced in lower exposure to sales, (3) improved profitability in Orbit's social housing letting business, allowing SHLIC to reach 2x, despite rising interest costs given the additional borrowing, or (4) a reduction in exposure to standalone derivatives.

Factors that could lead to a downgrade

Negative pressure on the rating could result from one or a combination of the following: (1) increased reliance on market sales revenue, with market sales representing over 35% of turnover, (2) higher capital expenditure such that net capital spend (capex) is sustained above 35% of turnover, or (3) operating margin sustained at levels below peers. In addition, a weaker regulatory framework, a dilution of the overall level of support from the UK government, or a downgrade of the UK sovereign rating would exert downward pressure on the rating.

Key indicators

Exhibit 2

Orbit Group

	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18 (E)	31-Mar-19 (F)
Units under management (no.)	37,452	37,336	38,494	39,231	40,610	42,121	42,803
Operating margin, before interest (%)	23.9	27.8	27.7	24.4	25.4	25.0	26.2
Net capital expenditure as % turnover	21.1	45.6	59.6	40.9	52.1	26.3	56.5
Social housing letting interest coverage (x times)	1.7	2.0	1.9	1.5	1.6	1.6	1.0
Cash flow volatility interest coverage (x times)	2.3	2.1	2.2	1.9	2.2	2.1	1.3
Debt to revenues (x times)	3.8	3.4	3.6	3.4	3.4	3.3	3.8
Debt to assets at cost (%)	41.2	39.1	46.2	48.5	50.8	50.8	52.0

Note: FY2018 are estimates, FY2019 are forecasts, interest coverage metrics in FY2019 incorporate breakage cost estimates from refinancing exercise. If breakage cost estimates are excluded, our social housing letting interest coverage and cash flow volatility interest coverage metrics in FY2019 would range between 1.4x - 1.5x, and 1.9x - 2.0x respectively.
Source: Orbit and Moody's Investors Service

Detailed credit considerations

On 31st May 2018, Orbit announced an issuance of between GBP250 million and GBP450 million in long-term backed senior secured bonds. The proceeds will be used to both repay existing loan facilities, simplifying Orbit's existing debt structure, and fund its growth strategy. The change in outlook to negative from stable reflects the higher capital expenditure associated with the housing association's increasing development programme, which results in lowering its liquidity coverage over the next 3-4 years, as well as increasing exposure to market sales.

The credit profile of Orbit, as expressed in the A2 rating combines (1) a baseline credit assessment (BCA) for the entity of a3 and (2) a strong likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline credit assessment

Continued strong interest coverage metrics

In FY2018, turnover from social housing letting operations is set to represent 56% of total turnover, lower than the A2-rated peer median of 77%. Orbit's social housing letting business has performed well in recent years; the operating margin for core social housing

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lettings is set to be 38% in FY2018, significantly stronger than the group's overall anticipated operating margin of 25%, reflecting nature of the lower margins from activities outside the core social housing business. The association's increasing exposure to non-core activities and specifically market sales have somewhat dampened overall operating margin in recent years. Going forward, Orbit expects margins on sales to be volatile, maintaining at 21% in FY2019 and subsequently falling to below FY2017 levels.

Given the strong margins from social housing letting, the surplus from these activities is set to cover FY2018 interest and financing costs by 1.6x, which would provide a sufficient buffer in supporting Orbit's interest obligations. This metric is forecast to maintain at 1.6x over the next few years, as a proportion of Orbit's planned bond issuance is set to refinance and simplify the housing association's existing debt structure, and would not materially increase Orbit's net debt position and interest obligations going forward (see section entitiled “Debt metrics in-line with peers, albeit projected to grow”). We note that the anticipated refinancing exercise could contract Orbit’s Social Housing Letting Interest coverage (SHLIC) to around 1x in FY2019 due to estimated breakage costs associated, which we capture as a financing cost. However, following FY2019, Orbit's SHLIC is set to return and stay at 1.6x. Moreover, if the anticipated refinancing exercise, and estimated breakage costs, were not undertaken, Orbit's SHLIC metric would range between 1.4x - 1.5x in FY2019.

Orbit's cash flow volatility interest coverage (CVIC), which measures the association's ability to meet interest payments using cash flow from operations (CFO), adjusted for volatility in historical CFO, is currently a credit strength for Orbit. In FY2018, the housing association's expected CVIC is 2.1x, in line with the A2-rated median of 2.1x. Our CVIC metric is forecast to maintain at 2.1x over the next five years, expect for in FY2019, where the metric is set to weaken to 1.3x due to the breakage cost mentioned above. Similarly, if the anticipated refinancing exercise, and estimated breakage costs, were not undertaken, Orbit's CVIC metric would range between 1.9x - 2.0x in FY2019.

Debt metrics in-line with peers and relatively stable, despite planned borrowing increase

As at May 2018, Orbit’s outstanding debt equated to 51% of assets-at-cost, or 3.3x revenue. In absolute terms, Orbit’s debt has increased by 62% over the last four years and is estimated to increase a further 12% in FY2019 to reach £1.37 billion, and steadily grow to reach £1.66 billion by FY2022. The additional funding requirements is driven by the group's growing development programme. Orbit's debt to revenue metric is expected to marginally weaken over the next four years, increasing from 3.3x in FY2018 and to 3.8x in FY2019 and gradually decrease across the four year period to 3.6x, which is in line with A2 rated peer medians. Debt to assets (at cost) will maintain at approximately 52% across the same period, however this is weaker than peer median of 45%. The stability in Orbit's debt metrics are supported by the housing association's anticipated revenues and asset base growing in line with the increase in debt. We note however that increasing Orbit's debt position will challenge its credit quality, as relatively low debt had been a key factor in organisation’s strong financial metrics.

Sizeable pool of unencumbered assets

As at May 2018, Orbit had unencumbered assets sufficient to support an additional estimated £819.7 million worth of borrowing, easily covering planned borrowing for the next five years, while providing a buffer against potential mark-to-market calls on Orbit’s standalone swap portfolio. Orbit's unencumbered asset position somewhat counterbalances the risks baked into the group's ambitious development plan to deliver approximately 8,600 units over the next five years.

Orbit’s treasury policy is more prudent when compared to peers at this rating level. The treasury policy stipulates that Orbit should maintain sufficient cash to cover the next three months of forecast cash requirement, and sufficient cash and secured facilities to cover the next twelve months of forecast cash requirement. In addition, cash and committed unsecured loan facilities are to cover the business plan's net cash requirement and uncommitted development spend.

Ambitious development plan increasing capital expenditure and market sale exposure

Orbit plans to develop 8,600 new homes by FY2022, leading to an increase in net capex during this period of £540 million compared to the group's previous business plan. As such, in FY2019, planned net capex as a percentage of turnover remains high at 56% and is set to average 42% over the next four years. Orbit's development programme has increased by approximately 10% to 8,600 units, althought the group's management team aim to keep the tenure split proportions largely unchanged; 37% of properties for affordable rent, 27% for first tranche shared ownership, and 28% for outright sale and market rent. Although the proportions of the tenure splits

have remained similar to those in the previous business plan, by increasing the scale of development with exposure to the cyclical housing market, Orbit is increasing operations that are inherently riskier.

In FY2018, an estimated 44% of Orbit's revenues are expected to derive from non social housing activities. Revenues from sales would represent the main component of non-core operations, accounting for approximately 37% of total revenues and continuing an upward trend. The contribution of sales to turnover is set to increase to 42% by FY2020 and we consider this to be relatively high exposure to the cyclical housing market. Significant sales programmes generally lead to more volatile cash flows, and inability to reach sales expectations could require additional debt to fund any potential financing gap, potentially impacting debt metrics going forward. Hence, Orbit's ability to manage the sales programme will be an important credit factor moving forward.

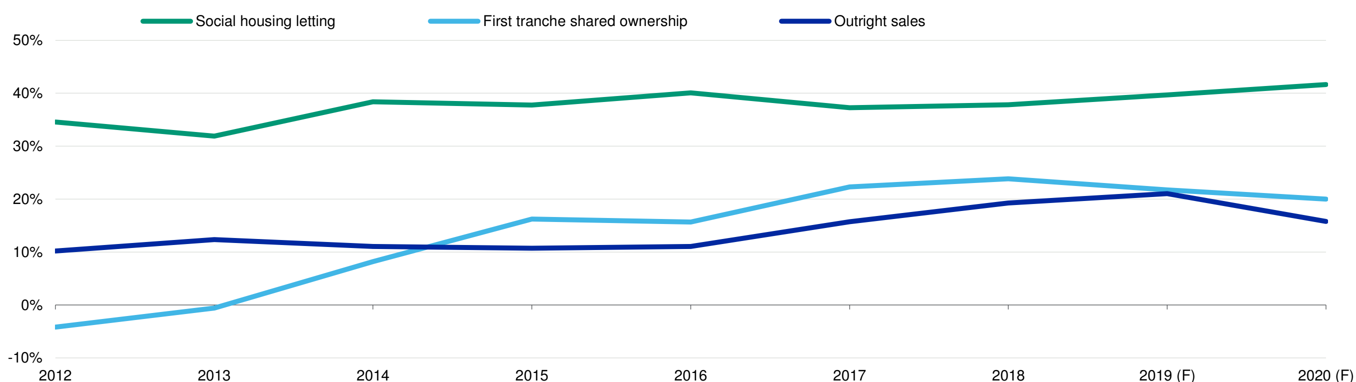
As at May 2018, Orbit's liquidity position, comprised of cash and cash equivalents and immediately available undrawn facilities was £51 million and £187 million respectively, for a total of £238 million liquid assets. Despite a strong liquidity position, Orbit's liquidity coverage ratio in FY2018, which measures liquidity against the following two years of planned net capital spend (capex), is 0.8x, which is a material deterioration of Orbit's liquidity cover metric for the same year of 2.36x based on the group's previous business plan. The weakening of this metric has been driven by the planned increase in capex while liquidity has remained at a relatively similar level. Although liquidity cover does improve to 1.37x in FY2019 due to an anticipated boost in funds following the bond issuance, it continues to remain below 1x and further weaken in later years as the bond proceeds and other facilities are used to fund the group's strategy. Orbit's weakening ability to fully cover forthcoming planned capex will place downward pressure on the housing association's credit quality.

Supplementing its social housing and sales activities, Orbit has a significant asset disposals programme which is set to generate around £24 million in FY2018. The assets sales are part of a programme of stock rationalization and void sales, which are expected to continue and increase for the next few years. Proceeds from disposals will support total margins and serve to moderate net capex going forward.

Weaker operating margin driven by lower margin sales activity

Since FY2015, Orbit has recorded lower operating margins than its rated peers. Margins currently are expected to be at 25%, compared to a 30% median for A2 rated peers. Orbit's operating margins are forecast to maintain at this level, averaging 26% over the next five years. While the operating margins from Orbit's social hosing letting business have historically been strong and are forecast to remain above 35%, the operating margins from sales activity have dampened this performance as they tend to be lower and more volatile (Exhibit 3). As such, the group's is set to see little improvement in its operating margin as its development programme comprises of 50% of units with market sales exposure.

Exhibit 3
Operating margins from social housing letting are higher and stable relative to sales



Source: Orbit and Moody's Investor Services

Exposure to capital market volatility as a result of standalone-swap portfolio

Orbit is exposed to capital market volatility as a result of its large portfolio of standalone swaps. As of May 2018, the portfolio stood at a notional amount of £316.5 million with a mark to market exposure of £102.2 million, down from £117 million in August 2017. The

group has a combination of cash and property collateral posted on the swap portfolio. Favourably, Orbit has a sizeable pool of assets that can be posted as collateral, as discussed in Orbit's credit strengths, which limits the liquidity risk associated with this exposure. Furthermore, Orbit's treasury policy requires them to stress test the negative impact of 50bps movements in interest rates, and to reserve aside enough security to cover this exposure.

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 Orbit and the UK government reflects their strong financial and operational linkages.

Moody's related publications

European Social Housing Providers, April 2018 (1113602)

Government-Related Issuers, August 2017 (1047378)

Ratings

Exhibit 4

Category	Moody's Rating
ORBIT GROUP LIMITED	
Outlook	Negative
Issuer Rating -Dom Curr	A2
ORBIT CAPITAL PLC	
Outlook	Negative
Senior Secured -Dom Curr	(P)A2

Source: Moody's Investors Service

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