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PUBLIC SECTOR EUROPE

CREDIT OPINION
5 October 2016

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RATINGS

Notting Hill Housing Group

Domicile	United Kingdom
Long Term Rating	A2
Type	LT Issuer Rating - Fgn 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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Notting Hill Housing Group

Update to Key Credit Factors

Summary Rating Rationale

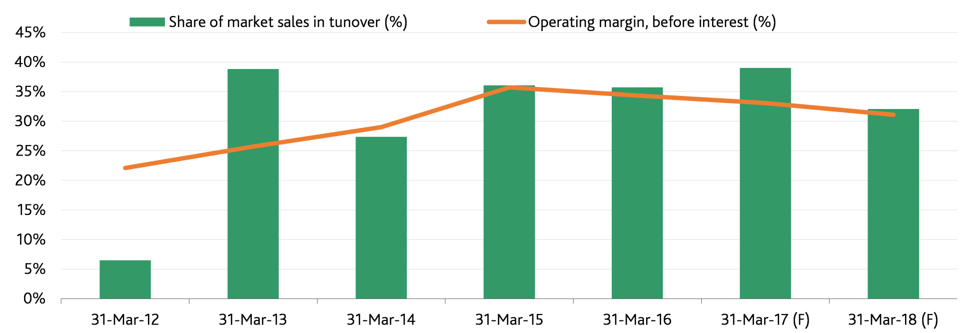
The A2 issuer rating assigned to Notting Hill Housing Group (Notting Hill) reflects its (1) strong operating performance driven by highly profitable market sales activity; (2) relatively low level of indebtedness; (3) strong liquidity position; and (4) the strong regulatory framework governing English housing associations. The rating also takes into account its (1) high exposure to market sales, (2) large development programme, and (2) weak cash flow volatility interest cover.

Ratings in the sector benefit 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 Notting Hill faces acute liquidity stress.

Notting Hill is rated at the mid-range of Moody's-rated English housing associations, whose ratings span from Aa3 to Baa1. Its relative position reflects its sizable balance sheet, with an operational focus across London, but higher exposure to market sales resulting in volatile operating cash flows.

Exhibit 1

Notting Hill's profitability will remain strong, supported by market sales activity
Operating margin and share of market sales in turnover, FY2012-FY2018



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

Credit Strengths

» Improved operating performance driven by highly profitable market sales activity

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

» Strong liquidity position

» Strong regulatory framework

Credit Challenges

» High exposure to market sales, used to fund substantial development programme

» Weak cash flow volatility interest cover, although expected to improve

» Government policy changes make operating environment more challenging for housing associations

Rating Outlook

The negative outlook on Notting Hill's rating reflects the negative impact of the vote to leave the European Union (EU) on housing associations as well as the negative 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

Moody's believes that upward ratings pressure on the HAs affected by the UK Sub-Sovereign Brexit action is unlikely to develop in view of the challenging operating environment and weakened sovereign credit conditions. Strengthening credit metrics of standalone credit profiles, however, could put upward pressure on Notting Hill's rating.

A combination of the following could have positive rating implications: (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; and (4) greater stability in operating cash flows resulting in cash flow volatility interest cover which consistently exceeds 2.0x.

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 or a dilution of the overall level of support from the UK government would also exert downward pressure on the rating.

Recent Developments

On June 23rd, 2016, the UK voted to leave the EU in a referendum and on June 24th, 2016, a negative outlook was placed on the UK's Aa1 sovereign rating. We expect protracted trade negotiations, resulting in a high level of uncertainty in the medium term which will manifest in slower economic growth. On June 29th, 2016, the outlook on Notting Hill's A2 rating was changed to negative from stable reflecting the potential impact of the vote to leave the European Union on associations. Housing associations (HAs) could be affected by renewed pressure on public finances resulting in further policies that would squeeze HA revenues and any further social housing policy changes exacerbating the policy instability that currently underpins our negative outlook on the sector. In addition, the potential loss of EU funding as well as volatility in the UK housing market could constrain the creditworthiness of the sector. The outlook changes also reflect the change in the outlook of the sovereign rating to negative from stable, reflecting the close operational linkages between the central government and HAs.

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.moodys.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 2

	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16
Units under management (no.)	27,135	27,170	28,418	29,573	30,679
Operating margin, before interest (%)	22.1	25.7	29.0	35.7	34.4
Housing assets (GBP million)*	1034	1098	1227	2940	3034
Net capital expenditure as % turnover	111.9	-1.3	87.5	34.4	31.2
Social housing letting interest coverage (x times)	1.3	1.4	1.0	1.0	1.2
Cash flow volatility interest coverage (x times)	0.0	2.4	-0.4	1.5	1.2
Debt to revenues (x times)	4.7	2.9	4.0	3.1	3.1
Debt to assets at cost (%)*	38.6	36.7	39.3	46.9	44.6

*from FY2015 figures are based on FRS102-compliant financial statements. The significant increase in the value of housing assets in FY2015 is a result of accounting changes which report the deemed cost gross value of housing assets rather than the book value net of social housing grant as in previous years. The adverse movement in gearing reflects an impairment of other assets on transition to deemed cost of GBP407 million. Excluding the impairment, gearing shown above as 44.6% would have been 38% in FY2016.
Source: Moody's, Notting Hill Group financial statements and forecast

Detailed Rating Considerations

Notting Hill's A2 rating combines (1) a baseline credit assessment (BCA) for the entity of baa1 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

STRONG OPERATING PERFORMANCE DRIVEN BY HIGHLY PROFITABLE MARKET SALES ACTIVITY

Notting Hill's profitability weakened slightly in FY2016, but will remain strong relative to peers. The operating margin was 34% in FY2016 (FY2015: 36%) compared to the median of 29% for its A2-rated peer group (based on FY2015 data). Although the operating margin dipped in FY2016, Notting Hill's operating margin has improved substantially over the last five years up from 22% in FY2012 driven by improved profitability in both core and non-core activities.

Notting Hill had another very strong year for its market sales activity in FY2016, with sales margins among the highest in Moody's rated portfolio. Its margin on market sales activity reached a five-year high of 42% in FY2016 up from 39% in FY2015. The high margins are attributable to management's experience in the property market as well as the recently buoyant London property market.

Notting Hill's market sales are concentrated in London and the South East. As of June 2016, house prices had increased by 9% in one year across the UK, but falls were recorded in some high-value areas in London. With the property market potentially cooling in London, Moody's will continue to monitor Notting Hill's level of exposure and performance. Going forward, margins on sales activity in the business plan are attainable given past performance, and are expected to decline from 35% in FY2017 to 21% by FY2019.

Notting Hill's operating margin on the core social housing business of 35% in FY2016 has also improved to levels in line with peers. The profitability of the core business has hitherto been constrained by higher than average operating costs, partially attributed to the age and nature of its housing stock. Notting Hill's management are proactively addressing their relatively higher cost base with a specific focus on its repairs and maintenance provision, however significant gains over the next five years will be challenging in the current operating environment (see Government policy changes make operating environment more challenging for housing associations). We expect profitability on the core business to remain near 30% over the next few years.

RELATIVELY LOW LEVEL OF INDEBTEDNESS, ALTHOUGH EXPECTED TO INCREASE TO FUND DEVELOPMENT

Notting Hill has a strong balance sheet relative to peers, with gearing (debt to assets at cost) lower than that of its A2-rated peers, a credit strength. At FYE2016, Notting Hill's debt was GBP1.3 billion, equivalent to 3.1x revenues and 45% of assets at cost compared to A2-rated peer medians for debt to revenues and gearing of 4.1x and 55% respectively in FY2015.

As part of the transition to FRS102, Notting Hill elected to revalue the majority of its properties resulting in both a significant increase in its revaluation reserve at FYE2015 to GBP723 million as well as a negative impact on reserves at FYE2015 of GBP466 million reflecting a recognised impairment for properties whose values had gone down. If we exclude the impact of the impairment on reserves, gearing at FYE2016 would have been 38%. The adverse movement in the gearing ratio as a result of FRS102 does not impact our view of Notting Hill's balance sheet strength, which we consider to be strong.

Additional borrowing to support growth will exert downward pressure on key debt metrics, although we expect performance to remain in line with peers. The development programme will be funded with additional debt of GBP1 billion over the next five years, with peak debt of GBP2.3 billion reached in FY2021. Debt to revenues will weaken to levels averaging 3.9x, broadly in line with A2-rated peer medians. Gearing will increase slowly as debt levels rise, but remain below levels of A2-rated peers.

As part of the new financial reporting framework, HAs in the UK were required to report FRS102-compliant accounts from March 2016, including comparatives for March 2015. Categories of the accounts which are most impacted include: housing assets, social housing grant, pensions, and financial instruments. Housing assets may be valued at cost or valuation as under the previous framework, or at deemed cost, which is a revaluation of housing assets at the date of transition. Social housing grant is no longer deducted from the cost of housing assets, but rather recognised as a long-term creditor and amortised. Moody's will continue to adjust gearing to exclude the revaluation reserve, whether an HA values its assets at deemed cost or valuation. Notting Hill has adopted deemed cost for its housing assets, resulting in a significant increase in the balance sheet valuation of its assets. However, this was offset by a substantial reduction in capital grant. The revised treatment has had an adverse effect on the gearing ratio, increasing it on transition by approximately 8%.

STRONG LIQUIDITY POSITION

Notting Hill's liquidity position is strong, which partially mitigates the risk associated with its large market sales programme. As of June 2016, Notting Hill had immediately available liquidity (cash and secured facilities) totalling GBP457 million, which is equivalent to 110% of turnover compared to a Moody's-rated portfolio median of 94%. On a forward-looking basis, Notting Hill's immediately available liquidity is sufficient to cover 1.1x two years of cash need, which includes capital spend. Notting Hill's treasury policy requires sufficient cash and immediately available facilities to cover the higher of the committed development programme or the next 12 months' cash needs.

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 2016, swap contracts had a negative mark-to-market value net of thresholds of GBP23 million. In cases where Notting Hill has exceeded the threshold amount, property has been posted. Moreover, ample unencumbered assets (estimated at GBP1,591 million in June 2016) ensures further margin calls can be properly met.

Notting Hill has an unsecured loan of JPY5 billion (equivalent to GBP28 million) from a Japanese investor which was arranged in 2015. The exchange rate risk is fully hedged via a cross-currency swap. This type of loan is unique in the sector, but is not material relative to Notting Hill's debt portfolio of GBP1.3 billion.

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 the ability to award capital grant funding, levy financial penalties, and impose independent inquiries or appoint new managers and officers in extreme circumstances. The HCA emphasizes that their role is a co-regulatory one with the primary onus being on boards and executive teams to ensure compliance with the standards.

As part of the Housing and Planning Act 2016, the Regulator's powers will be weakened in several areas including: removal of the consent to dispose of housing assets, removal of constitutional consents for group restructuring including mergers, and stricter conditions for appointing officers. The dilution of regulatory oversight and power is credit negative, although we expect the Regulator to continue to take an active role in managing risk in the sector.

HIGH EXPOSURE TO MARKET SALES, USED TO FUND SUBSTANTIAL DEVELOPMENT PROGRAMME

Notting Hill continues to diversify from its core landlord business into market sales and other activities, which elevates its risk profile. 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 52% in FY2016 is far below the A2-rated FY2015 peer median of 86% and constrains its credit quality.

Forecasts show high and volatile turnover from market sales over the next five years. Moody's define a high level of market exposure as more than 20% of turnover. On average, market sales will constitute 41% of total turnover for Notting Hill over the next five years, but the percentage will range between 32% in FY2018 to 50% in FY2019. 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, ranging from 20% to 35%.

Notting Hill's development programme is ambitious for its size and assumes an average of 1,300 new homes will be built per year over the next five years (including uncommitted). Notting Hill has several large London sites in its pipeline, including the Aylesbury Estate, Canada Water, and Lampton Road in Hounslow. The focus on large developments poses some concentration risk, but the phased nature of these developments partially mitigates the exposure. Development will include a variety of tenures, with shared ownership comprising the largest share of total units at 37%, followed by outright sales at 24%, affordable rent at 19%, market rent at 13% and general needs rent at 7%. Net capex to revenues will average 49% over the next five years, compared to an A2-rated FY2015 peer median of 32%.

The development programme is the primary driver behind Notting Hill's substantial debt growth over the next five years, reaching GBP2.3 billion by FYE2021 compared to GBP1.3 million at FYE2016. Although development plans are ambitious, Notting Hill will retain some flexibility in its capital plans, as only 50% of capex in the business plan is committed (as of June 2016).

WEAK CASH FLOW VOLATILITY INTEREST COVER, ALTHOUGH EXPECTED TO IMPROVE

Notting Hill's cash flow volatility interest cover (CVIC) ratio is lower than peers, reflecting the volatility in its operating cash flows as a result of its high exposure to market sales. Notting Hill's CVIC was 1.2x in FY2016, down from 1.5x in FY2015 relative to a Moody's-rated peer median (in FY2015) of 1.7x. We expect the CVIC to improve over the next few years to levels averaging 1.7x as 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, improved in FY2016 to levels in line with peers but is expected to weaken over the next five years. The ratio improved to 1.2x in FY2016 from 1.0x in FY2015 but has dropped from its five-year historical peak of 1.4x in FY2013. Over the next five 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 average 1.1x during FY2017-FY2021.

GOVERNMENT POLICY CHANGES MAKE OPERATING ENVIRONMENT 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 July 8th, 2015 the UK government announced (1) a change in the social housing rent formula to 1% annual reduction starting from April 2016 for four 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 ties to the government, which we view as credit positive, by creating a more unpredictable operating environment and undermining the extent and stability of housing benefit's contribution to revenues.

Our preliminary assessment indicates 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 (83% in FY2015).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 19% of Notting Hill's total income, compared to 29% average for Moody's-rated peers. Notting Hill put in place a range of mitigating measures to respond to Welfare Reform, including proactive management of rent arrears, support for tenants or 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, but creates a risk of a longer term erosion of social housing stock. Notting Hill has not included any income from Right to Buy sales in its business plan.

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, which 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 Notting Hill 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, October 2014 (173845)

Ratings

Exhibit 3

Category	Moody's Rating
NOTTING HILL HOUSING GROUP	
Outlook	Negative
Issuer Rating	A2
PARENT: NOTTING HILL HOUSING TRUST	
Outlook	Negative
Senior Secured -Dom Curr	A2

Source: Moody's Investors Service

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