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CREDIT OPINION
27 January 2022

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RATINGS

Connexus Homes Limited

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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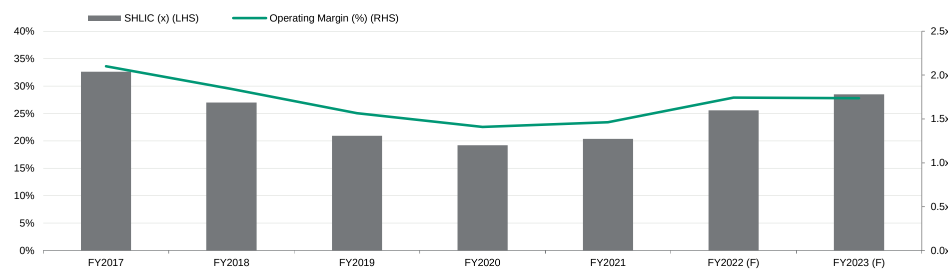
Connexus Homes Limited (United Kingdom)

Update to credit analysis

Summary

The credit profile of Connexus Homes Limited (Connexus, A3 stable) reflects its solid interest cover ratios and the post-merger simplification of its group structure. The rating also considers Connexus' high level of gearing and ambitious development plan. In addition, the sector benefits from the strong regulatory framework governing English HAs, and our assessment of a strong likelihood that the Government of United Kingdom (UK, Aa3 stable) would intervene in the event that Connexus faced acute liquidity stress.

Exhibit 1
Connexus' operating performance is expected to recover closer to historical levels
Operating margin (%) (LHS), social housing letting interest coverage (SHLIC, x) (RHS), FY2017-FY2023 (F)



F: Forecast
Source: Connexus and Moody's Investors Service

Credit strengths

» Interest cover ratios in line with peers, expected to strengthen

» Strengthening of management through simplification of group structure and activities

» Supportive institutional framework in England

Credit challenges

» High level of gearing, which is expected to moderate

» Ambitious development plan, with moderate to high exposure to market sales

Rating outlook

The stable outlook on Connexus reflects our expectation that its financial performance and debt metrics will remain in line with those of A3-rated peers.

Factors that could lead to an upgrade

Upward pressure on Connexus' rating could arise if it demonstrates a sustained improvement in operating performance, including a social housing lettings interest coverage at 1.5x or above and debt/revenue at 3.0x or stronger.

Factors that could lead to a downgrade

Downward pressure on Connexus' rating could result from a weakening in its financial performance metrics, including SHLIC and cash flow volatility interest coverage (CVIC), to levels close to or below 1x; a ramp-up in its risk appetite, including higher exposure to market sales than currently projected; and an increase in debt beyond our current expectations, with debt/revenue sustained at levels above 4.5x and gearing above 70%. In addition, a weaker regulatory framework or a dilution in the overall level of support from the UK government could exert downward pressure on the rating.

Key indicators

Exhibit 2

Connexus Homes

	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.)	10,030	10,527	10,648	10,741	10,867	10,959	11,297
Operating margin, before interest (%)	33.6	29.5	25.0	22.5	23.4	27.9	27.8
Net capital expenditure as % turnover	16.4	23.9	16.8	6.7	(5.3)	43.3	10.5
Social housing letting interest coverage (x times)	2.0	1.7	1.3	1.2	1.3	1.6	1.8
Cash flow volatility interest coverage (x times)	2.4	2.9	2.3	2.8	3.0	2.3	2.8
Debt to revenues (x times)	3.3	3.6	3.7	3.8	3.2	3.4	2.9
Debt to assets at cost (%)	63.4	62.7	62.9	62.8	59.2	56.1	54.7

F: Forecast
Source: Connexus and Moody's Investors Service

Detailed credit considerations

Connexus' A3 rating combines a Baseline Credit Assessment (BCA) of baa2, with (1) our assessment of the very high default dependence between Connexus and the UK government and (2) a strong likelihood of extraordinary support in the event that the entity faces acute liquidity stress.

Baseline credit assessment

Interest cover ratios in line with peers, expected to strengthen

Connexus' SHLIC increased slightly to 1.3x in fiscal 2021 from 1.2x in fiscal 2020, in line with the A3-rated peer median. We expect its SHLIC to improve significantly over the next three years, averaging at 1.7x over the period due to a combination in improvement in social housing operating performance. Connexus' social housing lettings margin was 26% in fiscal 2021, up slightly from 25% in fiscal 2020, and is expected to increase to 33% by fiscal 2024, underpinned by the return to inflation-linked rent growth. However, we note that Connexus continues to catch up on maintenance and repairs following the impact of lock-downs during the pandemic which may delay some of the recovery in its margins.

Connexus' CVIC remained significantly stronger than peers in fiscal 2021, at 3.0x compared to the A3-rated peer median of 1.7x. Connexus has benefitted from increasing operating cash flows thanks to improved sales margin. We expect CVIC to remain strong, averaging 2.6x over the next three years.

Despite a moderate debt increase, Connexus will benefit from stable net interest costs going forwards, underpinning its strong interest cover ratios. Net interest costs are expected to rise marginally to £10.5 million in fiscal 2024 from £10 million in fiscal 2021 as the HA benefits from low indebtedness relative to budget.

Connexus' operating margin stabilised at 23% in fiscal 2021, below the A3-rated peer median of 25% and lower than its historical levels of above 30% in prior years. The decline was predominantly driven by merger-related costs on human resources, IT systems and maintenance over the past two years. As part of the priorities set out at merger, Connexus targeted £2 million of recurring savings by fiscal 2021, with actual result being £0.05 million short. Going forwards, Connexus expects its operating margin to improve to 31% by fiscal 2024, underpinned by rent increases and the organisation's transformation. Catch up on maintenance and repairs as well as inflation may slow this recovery. Connexus is aiming to deliver additional savings and cost efficiencies of around £1 million over fiscal 2022-23.

Strengthening of management through simplification of group structure and activities

Connexus' structure simplification is ongoing, a credit positive as it enables more effective oversight and control over the entity. A transfer of engagements took place in April 2021, consolidating its four registered providers into one entity. Connexus had a complex structure following its merger with Herefordshire Housing in July 2017, with four registered providers and eight other subsidiaries. Connexus is in the process of striking off three subsidiaries (Floreat Developments Limited, Enterprise 4 Limited and Shropshire Housing Treasury Limited) which became duplicate subsidiaries following the merger. The group has no joint ventures and has on-lending limits for its subsidiaries. We will continue to monitor the simplification of the group structure.

The Group also re-centered its activities, having mostly exited the supported housing sector, which previously had negative operating margins. Connexus maintains a very small exposure to care, representing 3% of 2021 turnover. Contrary to peers and despite the negative impact of the pandemic, Connexus' margins on care have remained positive in the past two years, having averaged 11%.

Connexus continues to develop its internal controls, introducing forward looking Early Warning Indicators with trigger points (on inflation, build costs, voids etc.) which will act as a review to consider whether or not to undertake some of the mitigating actions outlined in its stress testing. Mitigations include suspending refurbishment works, only undertaking major works and removing non-pay discretionary spend. Connexus' golden rules are maintaining operating margin above 25%, interest cover above 131%, net debt per unit below £32.8k and holding 18 months liquidity.

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong institutional framework governing English housing associations (HAs) reflected in an Operating Environment score of a2 and a Regulatory Framework score of a1. These scores are assigned at a national level and reflect the following credit considerations:

The English 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. In response to the pandemic, the regulator adapted some aspects of its oversight temporarily, for example, extending its liquidity monitoring, briefly pausing the programme of IDAs and delaying regulatory submissions to reduce the operational burden on 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.

High level of gearing, which is expected to moderate

Connexus' gearing declined to 59% in fiscal 2021 from 63% in fiscal 2020, as gross debt declined to £223 million from £246 million the year before, a positive. Despite the decline, gearing remained higher than the 53% median for A3-rated peers. The high gearing is largely a function of the organisation's history, as both Shropshire and Herefordshire, the entities that merged to form Connexus, were Large Scale Voluntary Transfers.

Whilst gearing is high, debt/revenue significantly outperforms peers thanks to Connexus' moderate debt profile. Debt/revenue fell to 3.2x in fiscal 2021 from 3.8x in fiscal 2020, well below the A3-rated peer median of 4.5x. We expect debt/revenue to remain stable between fiscal 2022-24, averaging 3.3x as Connexus will benefit from increased revenue following unit completions and inflation-linked rents.

Connexus' debt profile is expected to remain broadly stable in absolute terms, increasing to £240 million by fiscal 2024 from £223 million in fiscal 2021, to fund the issuer's development programme. Connexus' debt structure is simple, with 83% fixed and 17% variable as of fiscal 2021, and with moderate refinancing risk with 15% of debt due within five years. Moreover, Connexus had unencumbered assets of £120 million as of fiscal 2021, representing enough to cover the next 5 years of net funding needs, a positive.

Ambitious development plan, with moderate to high exposure to market sales

Connexus plans to deliver circa 1,100 new units over the next five years, or 10% of its current units, a significant increase. However we note that it represents 200 units per year, a close output to the one delivered in fiscal 2021: 189 new units against a target of 143. As a consequence, the HA's net capital spending will increase to 24% of turnover over the next three years from -5% in fiscal 2021. In addition to the development plan, we expect capital spending to increase in the coming years to retrofit existing units to meet the government's targets in terms of decarbonisation. Although the HA has included an initial estimate of spending related to energy efficiency and decarbonisation in its latest business plan, we expect the estimated costs to increase in the next business plan as the HA conducts a full stock condition survey.

Despite the ambitious increase in capital spending, Connexus maintains a high liquidity coverage ratio, underpinned by its golden rule to maintain 18 months of liquidity. As of December 2021, the HA held £71.5 million of undrawn liquid facilities through its revolving credit facilities and £5 million of cash, or a liquidity coverage ratio of 2.1x, higher than A3-rated peers (median of 1.4x).

67% of the units Connexus plans to develop will be for social rent, and 33% for market sales. Although the higher share of units developed for rent is positive as market sales tend to have more volatile cash flows and margins than social rented property, Connexus will maintain a moderate to high exposure to market sales risk over the next three years. Connexus have a sales at risk cap of £15 million for outright sales but currently remains well below this level at £0.4 million from one unsold unit as of October 2021. Connexus' high exposure to market sales (that we define as 20-30% of turnover) of 22% in fiscal 2021 should decrease to an average of 16% over the next three years. Connexus' outright sales programme (9% of turnover over the next three years) is concentrated in one main scheme: Radbrook Village, which has completed on three phases and currently has a proposed Phase 4.

Extraordinary support considerations

Connexus receives a strong level of extraordinary support, reflected by 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 in increasing exposure to non-core social housing activities in the sector, which add complexity to HAs' operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more difficult. In addition, our assessment that there is a very high default dependence between Connexus and the UK government reflects their strong financial and operational links.

ESG considerations

How environmental, social and governance risks inform our credit analysis of Connexus

We take account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Connexus, the materiality of ESG factors to its credit profile is as follows:

Environmental considerations are material to the Connexus' credit profile. Although the impact of physical climate risks such as water shortages and flood risk are unlikely to be material to HAs' credit profiles as they are managed by government authorities, energy efficiency and decarbonisation more broadly are becoming an increasingly acute priority for HAs with a target of all homes obtaining an energy performance certificate (EPC) of C or above by 2035 in England. We expect this to require material levels of capital expenditure - which would either divert cash flows away from development programmes or increase debt levels. Connexus has included an initial estimate of energy efficiencies costs in its business plan.

Social risks are material to HAs' credit profiles. 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 pandemic as a social risk under our ESG framework given its impact on health and safety. Overall, we expect the pandemic to cause ongoing operational disruption for HAs, but we do not expect a significant 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, HA governance is strong with multiyear strategies supported by detailed forecasts, conservative liquidity policies and robust risk management including stress testing.

Further details are provided in the "Baseline credit assessment" 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 baa2 is close to the scorecard-indicated BCA of baa1.

The methodologies used in this rating were European Social Housing Providers, published in April 2018, and Government Related Issuers, published in February 2020.

Exhibit 3

Connexus' 2021 scorecard

Connexus Homes			
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%	10,867	baa
Factor 3: Financial Performance			
Operating Margin	5%	23.4%	baa
Social Housing Letting Interest Coverage	10%	1.3x	baa
Cash-Flow Volatility Interest Coverage	10%	3.0x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	3.2x	baa
Debt to Assets	10%	59.2%	b
Liquidity Coverage	10%	2.1x	aa
Factor 5: Management and Governance			
Financial Management	10%	ba	ba
Investment and Debt Management	10%	baa	baa
Scorecard - Indicated BCA Outcome			**baa1**
Assigned BCA			**baa2**

Source: Connexus and Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
CONNEXUS HOMES LIMITED	
Outlook	Stable
Issuer Rating -Dom Curr	A3
HEREFORDSHIRE CAPITAL PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

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