

## CREDIT OPINION

10 June 2021

 Rate this Research

### RATINGS

#### Orbit Group 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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## Orbit Group Limited

### Update to credit analysis

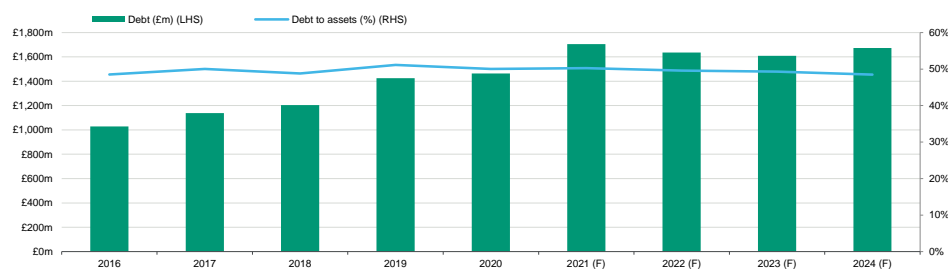
#### Summary

The credit profile of [Orbit Group Limited](#) (Orbit, A3 stable) reflects its established market position, sufficient liquidity and sizeable unencumbered asset position, traditionally stable debt metrics, and the group's straightforward governance structure. Counterbalancing the strengths of Orbit are the sizeable development programme, an increasing proportion of forecast revenue stemming from market sales, and large exposure to standalone swaps. Orbit benefits from the strong regulatory framework governing English housing associations and our assessment that there is a strong likelihood that the government of the [United Kingdom](#) (UK, Aa3 stable) would intervene in the event that Orbit faced acute liquidity stress.

Exhibit 1

#### Orbit's gearing and debt is expected to remain stable over the next four years

Debt in £ millions (LHS), debt to revenues in percentage (RHS)



F = indicates forecast

Source: Orbit, Moody's Investors Service

#### Credit strengths

- » Ample liquidity and sizeable pool of unencumbered assets
- » Debt metrics forecast to remain relatively stable
- » Strong market position, simple structure, adept governance and risk management

#### Credit challenges

- » Ambitious development plan increasing capital expenditure and market sale exposure
- » Historically weaker operating margin than peers, driven by lower margin sales activity
- » Exposure to capital market volatility as a result of large standalone swap portfolio

## Rating outlook

The stable outlook on Orbit's rating reflects its projected stable debt metrics, strong market position and good liquidity.

## Factors that could lead to an upgrade

Upwards pressure on the rating could result from one or a combination of the following: (1) a material reduction in Orbit's planned development programme, further enhancing liquidity cover ratios and forecast debt metrics, (2) a reduced risk profile as evidenced in a reduction in exposure to market sales, (3) CVIC maintained at over 2x, and (4) enhanced overall profitability, with operating margins maintained near 30%.

## Factors that could lead to a downgrade

Negative pressure on the rating could result from one or a combination of the following: (1) increasing reliance on market sales revenues above currently planned levels, (2) further scaling up in the development plan, leading to a reduction in liquidity cover, and (3) a rise in borrowing above currently planned levels and a material weakening of debt metrics. In addition, a weaker regulatory framework or a dilution of the overall level of support from the UK could also exert downward pressure on the rating.

## Key indicators

Exhibit 2

Orbit Group	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21 (F)	31-Mar-22 (F)
Units under management (no.)	39,231	40,610	42,417	43,470	44,753	42,975	43,343
Operating margin, before interest (%)	24.4	25.4	25.4	27.3	28.0	25.4	27.3
Net capital expenditure as % turnover	40.9	57.6	24.9	49.1	47.0	17.1	32.7
Social housing letting interest coverage (x times)	1.5	1.6	1.6	1.6	1.5	1.6	1.6
Cash flow volatility interest coverage (x times)	1.9	1.7	2.1	0.7	0.4	1.5	1.6
Debt to revenues (x times)	3.4	3.4	3.4	4.5	4.5	5.0	4.5
Debt to assets at cost (%)	48.5	50.0	48.8	51.1	50.0	50.3	49.6

Source: Orbit, Moody's

## Detailed credit considerations

The credit profile of Orbit, as expressed in the A3 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

#### Ample liquidity and sizeable pool of unencumbered assets

As at 31st March 2020, Orbit's liquidity position, comprised of cash and cash equivalents and immediately available undrawn facilities, was £87 million and £214 million respectively. This level of liquidity provides 1.7x of coverage over the following 24 months of net cash needs. Orbit's liquidity is supported by the proceeds from Orbit's £300 million bond issuance in November 2020. We expect liquidity cover position to remain strong over the medium term as Orbit executes its development programme. We expect net capital expenditure to average £110 million per annum for the next three years, moderately lower than in FY2019 and FY2020 where net capex averaged £154 million. Orbit's liquidity has strengthened significantly in recent years, with the Group's latest issuance building on the £450 million bond in June 2018.

Orbit's ability to satisfy its funding requirements is supported by its strong unencumbered asset position, sufficient to support £774 million of additional borrowing, if required. This would easily cover 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 7,100 units over the next five years, a reduction on the previous plan of 8,700 units.

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Orbit's treasury policy is considered appropriate for its business plan. 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, one of the housing association's internal "golden rules" requires cash and arranged unsecured loan facilities are to cover 24 months of the business plan's net cash requirement and uncommitted development spend.

### **Debt metrics forecasted to remain relatively stable**

Orbit's debt has increased by a compounded annual growth rate (CAGR) of 9.2% since FY2016 and is expected to increase by a further 16.5% in FY2021 to reach £1.7 billion. According to Orbit's business plan, debt is expected to remain relatively stable over the next five years at £1.6 billion. At fiscal year end 2020, Orbit's outstanding debt equated to a gearing metric (debt to assets-at-cost) of 50%, which is in line with the A3-rated peer median of 53%. Orbit's gearing metric has been stable since FY2016.

Similarly, Orbit's debt to revenues metric has historically been stable at 3.4x since FY2016 and remained at this level to FY2018, stronger than the rated peer median of 4.3x. In FY2019, this spiked to 4.5x due in part to the gradual rise in debt, but mostly due to lower than forecasted sales revenues. We expect Orbit's debt to revenues to average 4.8x over the next two years, before declining closer to historical levels of 3.9x in FY2023.

The strengthening in the Orbit's debt to revenues from FY2023 onwards will be largely driven by income from market sales generated from completions in the Group's development programme. The stability in Orbit's debt metrics is supported by the housing association's anticipated revenues and asset base growing in line with the increase in debt.

### **Strong market position, simple structure, adept governance and risk management**

Orbit has been in operation for over 50 years, growing a portfolio which currently comprises of around 45,000 units focused predominantly in the Midlands, East of England, and South East regions. Since 2013, Orbit have delivered an average of 1,700 new units per year and it is planning to scale up its development plan to build 16,000 over ten years post-2020. Orbit is one of the UK's largest developers of social housing and has a strong presence within the markets it operates which is a credit strength. Orbit's size reflects a large balance sheet that can better provide resilience to potential financial stresses, relative to smaller housing associations.

Orbit's governance structure is straight forward and simple, consisting of Orbit Group Limited and Orbit Homes as registered providers. Orbit South and Heart of England, are tasked with the ownership and management of approximately 85% of the housing stock, and three unregistered entities responsible for specific roles. Orbit Capital Plc operates with the sole purpose of accessing capital markets for funding the group and its subsidiaries, Orbit Homes provides design and build services to support the group's development programme, and Orbit Treasury Limited provides treasury services to the registered providers.

Orbit's financial, debt and investment management is adept in enabling strong oversight and managing financial and operational risk through well-articulated policies and practices.

### **Ambitious development plan increasing capital expenditure and market sale exposure**

Orbit plans to develop 7,100 new homes by FY2025, equating to a net capex of £620 million during this period. In FY2020, net capex as a percentage of turnover remained high at 47% and is set to average 38% over the next four years. Its new development plan has moderately reduced its total development units with 1,300 fewer units planned to FY2025 when compared to its previous business plan. The tenure mix in Orbit's five year development programme will remain broadly similar to the previous plan, with general needs provision at 35%. The housing association aims to deliver a higher proportion of first tranche shared ownership units relative to last year, 36% from 32%. Outright sales contribute 20% of the development plan to FY2025, the same as in the previous plan but lower than historical targets.

In FY2020, 28% of Orbit's revenues derived from market sales activities, and this is expected to rise over the medium term. The contribution of sales to turnover is set to increase to 30% by FY2021 and we consider this to be very high exposure to the cyclical housing market. 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 in future years, potentially impacting debt metrics and interest cover ratios. Orbit's cash flow volatility interest cover (CVIC), which captures receipts from market sales, remains very low in FY2020 at 0.4x, down from

0.7x in FY2019. The low level of CVIC in the past two years has broadly been driven by higher interest costs and lower operating cash flows at £65 million in FY2019 and £55 million in FY2020, down from £117 million in FY2018. Lower market sales income has been the main factor in the Group's low CVIC metric in the past two years. This will strengthen to an average of 1.8x over the next three years, if Orbit achieves the level of sales in its current business plan, elevating operating cash flows to an average of £129 million per annum for the next three years.

Supplementing its social housing and sales activities, Orbit has a significant asset disposals programme which generated £40 million in FY2020. 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.

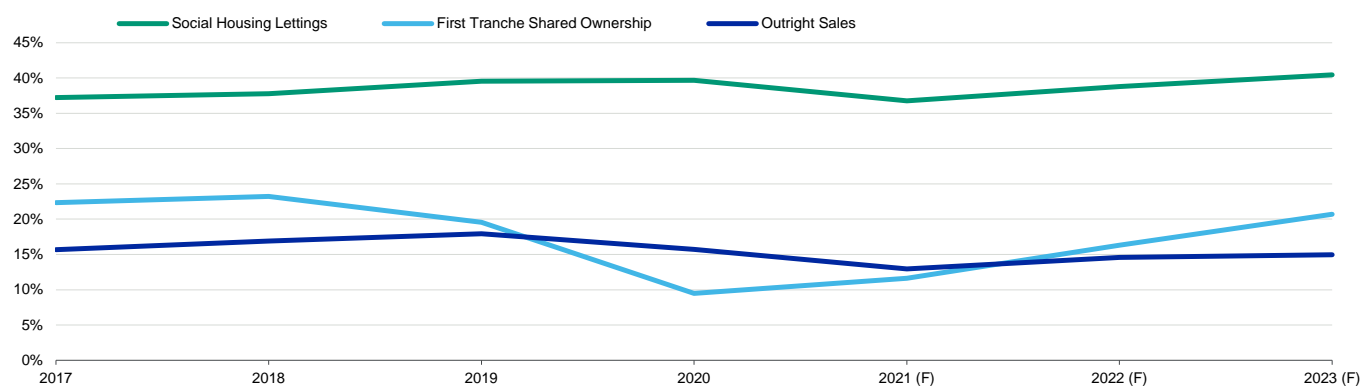
### Historically weaker operating margin than peers driven by lower margin sales activity

Since FY2015, Orbit has recorded lower operating margins than its rated peers. Orbit's margins have improved in FY2020 at 28%, compared to a 26% rated peer median. This improvement was driven by (Moody's adjusted) operating costs remaining stable at £233 million and the voluntary right to buy initiative. Orbit's operating margins are forecast to remain stable, averaging 28% over the next five years. The operating margins from Orbit's social housing letting business have historically been strong and are forecast to remain around 40%, however the operating margins from sales activity have dampened its overall performance as they tend to be lower and more volatile (Exhibit 3). As such, the group is set to see little improvement in its operating margin as its five year development programme comprises of 55% of units with market sales exposure.

Exhibit 3

#### Social housing letting margins remain higher and more stable than margins from sales

Social housing letting margin (%), FTSO margin (%), Outright sales margin (%)



Source: Orbit, Moody's

### 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 March 2020, the portfolio stood at a notional amount of £360 million with a mark to market exposure of £88 million, down from £106.8 million in March 2019. 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 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.

## ESG Considerations

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

Moody's takes 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 Orbit, the materiality of ESG to its credit profile is as follows:

Environmental considerations are not material to Orbit's credit profile. In line with the rest of the UK, the sector's main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by county and national authorities, and therefore the financial burden of adapting to increased flood risk will not fall on individual housing associations.

Social risks are material to Orbit's credit profile. 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 outbreak as a social risk under our ESG framework given its impact on health and safety. Overall, we expect the outbreak to cause ongoing operational disruption for HAs but do not expect a material 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 impacted 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, housing association governance is strong with multi-year 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

### Output of the Baseline Credit Assessment Scorecard

The assigned BCA of baa1 is the same as the scorecard-indicated BCA.

The methodologies used in this rating are [European Social Housing Providers](#), published in April 2018, and [Government-Related Issuers](#), published in February 2020.

Exhibit 4

31 March 2020

Orbit Group			
Baseline Credit Assessment	Sub-factor Weighting	Value	Score
<b>Factor 1: Institutional Framework</b>			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
<b>Factor 2: Market Position</b>			
Units Under Management	10%	44,753	a
<b>Factor 3: Financial Performance</b>			
Operating Margin	5%	28.0%	a
Social Housing Letting Interest Coverage	10%	1.4x	baa
Cash-Flow Volatility Interest Coverage	10%	0.3x	b
<b>Factor 4: Debt and Liquidity</b>			
Debt to Revenue	5%	4.5x	ba
Debt to Assets	10%	50.0%	b
Liquidity Coverage	10%	1.7x	a
<b>Factor 5: Management and Governance</b>			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
<b>Suggested BCA</b>			<b>baa1</b>
Sources: Orbit, Moody's			

Source: Moody's

## Ratings

Exhibit 5

<u>Category</u>	<u>Moody's Rating</u>
<b>ORBIT GROUP LIMITED</b>	
Outlook	Stable
Issuer Rating -Dom Curr	A3
<b>ORBIT CAPITAL PLC</b>	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

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