S&P Global Ratings

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Research Update:

U.K.-Based Notting Hill Genesis Downgraded To 'A-'; Outlook Stable

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Overview

- We believe Notting Hill Genesis (NHG) will see more pressure on its financial performance and debt servicing capacity over the next two to three years. This follows lower sales and higher integration costs than we had anticipated for financial year 2019 (FY2019).
- We acknowledge that NHG is responding to negative trends in the London housing market by scaling down the development side of its business, although this still contains a significant market element including the first tranche sales of shared ownership.
- We are therefore lowering our long-term issuer credit rating on NHG to 'A-' from 'A'.
- The stable outlook reflects our view that NHG's strong lettings business will continue to mitigate risks from sales exposure, and that NHG will continue to benefit from a moderately high likelihood of support from the U.K. government.

Rating Action

On June 5, 2019, S&P Global Ratings lowered its long-term issuer credit rating on U.K.-based social housing provider Notting Hill Genesis (NHG) to 'A-' from 'A'. The outlook is stable.

We also lowered our long-term issuer credit rating on NHG's subsidiary Notting Hill Home Ownership (NHHO) to 'A-' from 'A'. The outlook is stable.

We lowered to 'A-' from 'A' our issue ratings on NHG's five bonds (£250 million due in 2029, £250 million due 2032, £300 million due 2042, £400 million due 2048, and £250 million due 2054) including the latest 10-year maturity issued by the group in January 2019. We lowered to 'A-' from 'A' our issue rating on the £250 million bond, due 2039, issued by the treasury vehicle GenFinance II.

Rationale

Unlike in our previous rating review, none of the credit ratings referenced in this article is assigned by deviating from S&P Global Ratings' published criteria ("Methodology For Rating Public And Non

Profit Social Housing Providers," Dec. 17, 2014) when assessing the industry risk for housing associations.

The downgrades reflect NHG's weakened financial risk profile compared to our previous base case, driven by declining EBITDA margins and higher leverage than we anticipated in our previous forecast. Over the past 12 months, NHG has seen significant delays in property sales because of unfavorable market conditions in and around London. This has pressured the group's operating margins as well as its EBITDA interest coverage. However, we continue to view NHG's liquidity position as very strong as we do its social housing operations. This reflects its strong territorial footprint in London where we continue to see very strong demand for lettings and higher population growth compared to the U.K. average.

In our previous base case, we projected NHG to sell close to 1,000 units in FY2019, which included outright and first-tranche shared-ownership sale properties. However, with significant delays in sales receipts, NHG managed to sell only about 60% of its available market properties in the previous year, along with a bulk sale of 58 units made on a breakeven basis. These delays in sales, combined with falling house prices and higher marketing costs, weakened the group's financial performance and leverage position compared to our previous base case.

To mitigate the risk associated with unsold units, NHG has opted for tenure switches and significantly scaled down its development plan. Our base case also takes into account a bulk sale to be completed in the current financial year, but we do not include NHG joint venture activities nor do we include any potential sale of properties to a local authority. We expect unfavorable market conditions to persist at least for the current financial year and weigh further on the group's profitability, leading S&P Global Ratings-adjusted EBITDA margins to be consistently below 30% over our forecast horizon.

We have revised our assessment of NHG's industry risk because we now expect sales exposure in terms of revenue to drop below one-third of total projected revenue over our base case. We anticipate the number of units handed over to sales will decrease over our forecast and the sales plan will continue suffering in terms of prices and volume completed, at least while Brexit uncertainties persist. However, we understand that this reduction in sales activity may be temporary and may regain momentum once the housing market recovers. While NHG's development plan is scaling down in terms of unit volumes added to the portfolio, we observe that 50% of the program still contains market-related activities including first-tranche sales of shared-ownership, thereby maintaining pressure on our assessment of NHG's enterprise risk profile.

As a consequence of weaker financial performance, we project NHG's debt metrics to deteriorate such that our debt to adjusted EBITDA ratio exceeds 18.5x over the forecast period. This is higher than the 16.2x we anticipated in our previous review and higher than NHG's peers. Even if we foresee debt growing in line with our previous base case, the decrease in sales operating margins will translate into higher group leverage. NHG's non-sales EBITDA interest coverage will cover the group's interest payments by just over 1.0x during our forecast, which we view as a key ratings weakness compared to peers.

Our 'A-' rating on NHG is one notch higher than its stand-alone credit profile, reflecting our view of a moderately high likelihood of extraordinary support from the U.K. government, through the Regulator of Social Housing, in the event of financial distress. This reflects NHG's important role in the U.K. government and its public policy mandate. The government has a track record of providing strong credit support in certain circumstances.

We also continue to consider that NHG benefits from very strong economic fundamentals for its rental business given its presence in London, where over 85% of its properties are. The London region still benefits from higher population growth than the national average. This, and NHG's relatively low social and affordable rents compared with the average market rent, ensures solid demand for NHG's non-market rental activities. NHG has a large asset base of more than 66,000 units as a result of the merger completed in April 2018. We believe that controlling a large portfolio gives the group some flexibility to switch tenures, for example, and mitigate potential negative developments. Also, vacancy rates are expected to remain below 2%, reflecting the solid demand for its properties. Arrears, which we consider on gross basis, remain higher than peers nationwide at just below 8% of total rent receivable based on FY2019 estimate accounts (including service charge), but are in line with NHG's rated peers operating in London.

Liquidity

We continue to see NHG's liquidity position as very strong because of its large undrawn committed facilities and strong access to external liquidity. It issues regularly in the debt capital markets. This is despite the difficulties the group faces regarding its sales activities.

In our base case, we estimate sources of funds will cover uses by about 1.6x over the next 12 months.

Sources of liquidity will include:

- Cash flows from operations of close to £186 million;
- Cash and cash equivalents of £189 million;
- Proceeds from asset sales of around £127 million;
- Available funds under undrawn committed facilities of close to £646 million; and
- An expected cash injection in the form of government grants of £2 million.

Uses of liquidity will include:

- Capital expenditure of about £357 million;
- Interest and principal repayments of close to £360 million; and
- Grant repayment of around £27 million.

We view NHG's access to external liquidity as strong. Notting Hill Housing and Genesis Housing have demonstrated their ability to issue several bonds separately over the past few years and the newly amalgamated entity made its first £250 million 10-year maturity bond issuance in January 2019.

Outlook

The stable outlook reflects our view that NHG's strong underlying lettings business will continue to mitigate risks from sales exposure and that NHG will benefit from a moderately high likelihood of support from the U.K. government.

We could lower the ratings on NHG if we observed a further weakening of its financial risk profile beyond our current expectations. This could occur if the group's sales activities over the next few years put further pressure on its liquidity position or funding needs because of a severe housing market correction in London. We could also lower the ratings if we revised down our assessment of the likelihood of government support the NHG receives through the Regulator of Social Housing.

We could raise the ratings if we observed an improvement in financial performance along with contained exposure to sales activity. Under such a scenario, we would expect NHG to display adjusted EBITDA margins above 30%, significantly improve its EBITDA interest coverage, and maintain its debt to adjusted EBITDA ratio well below 20x.

Key Statistics

Table 1

Notting Hill Genesis

	--Year ended March 31--				
(Mil. £)	2018a	2019e	2020bc	2021bc	2022bc
Number of unites owned or managed	66,476	68,235	70,050	70,852	71,710
Vacancy rates (%)*	1.1	1.4	N.A.	N.A.	N.A.
Arrears (%)*	7.4	7.8	N.A.	N.A.	N.A.
Revenue§	694.6	649.7	733.3	786.8	705.3
Share of revenue from nontraditional activities (%)	33.0	29.4	36.5	39.0	29.4
EBITDA§†	198.9	173.2	183.8	204.0	206.0
EBITDA/revenue §†(%)	28.6	26.7	25.1	25.9	29.2
Interest expense**	135.2	123.8	129.4	136.7	140.2
Debt/EBITDA §†(x)	16.4	19.6	19.7	18.4	18.4
EBITDA/interest coverage§†** (x)	1.5	1.4	1.4	1.5	1.5
Capital expense†	473.1	395.1	356.2	364.0	307.4
Debt	3,267.7	3,401.7	3,617.0	3,753.4	3,779.8
Housing properties (according to balance sheet valuation)	6,500.7	6,804.4	7,010.7	7,281.1	7,517.6
Loan to value of properties (%)	50.3	50.0	51.6	51.5	50.3
Cash and liquid assets	201.4	105.9	193.2	145.1	20.0

*Rent and service charge. §Adjusted for grant amortization. †Adjusted for capitalized repairs. **Including capitalized interest. a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Ratings Score Snapshot

Table 2

Notting Hill Genesis

Industry Risk	2
Economic fundamentals and market dependencies	2
Strategy and management	3
Asset quality and operational performance	1
Enterprise profile	3
Financial performance	5
Debt profile	3

Table 2

Notting Hill Genesis (cont.)

Liquidity	2
Financial policies	3
Financial profile	4

S&P Global Ratings bases its ratings on non-profit social housing providers on the eight main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published on Dec. 17, 2014, summarizes how the eight factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating. For social housing providers generating more than a third of its consolidated revenues from open market sales, we also refer to the "Key Credit Factors For The Homebuilder And Real Estate Developer Industry."

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019

Ratings List

Downgraded		
	To	**From**
Notting Hill Genesis		
Senior Secured	A-	A
GenFinance II PLC		
Senior Secured	A-	A
Downgraded; Outlook Action		
	To	**From**
Notting Hill Genesis		
Notting Hill Home Ownership Ltd.		
Issuer Credit Rating	A-/Stable/--	A/Negative/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.