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Research Update:

U.K.-Based Notting Hill Genesis Downgraded To 'A' On Property Sales Risk; Outlook Negative

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Overview

- We project that Notting Hill Genesis (NHG) will increase its exposure to market-related activities to above one-third of its total revenues by financial year 2021.
- In our view, this level of exposure is significant for a regulated provider of social housing, and could increase NHG's revenue and earnings volatility, put pressure on its operating margins, and reduce its capacity to withstand downside risk.
- We are therefore lowering our long-term issuer credit rating on NHG to 'A' from 'A+'.
- The negative outlook reflects our view that high exposure to market-related activities may lead to a material weakening of NHG's debt service coverage, margins, and liquidity.

Rating Action

On July 27, 2018, 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 negative.

At the same time, we lowered our long-term issuer credit rating on NHG's subsidiary Notting Hill Home Ownership (NHHO) to 'A' from 'A+'. The outlook is negative.

We also lowered to 'A' from 'A+' our issue ratings on NHG's four bonds (£250 million due 2032, £300 million due 2042, £400 million due 2048, and £250 million due 2054), issued by Notting Hill Housing. Finally, we lowered to 'A' from 'A+' our issue rating on the £250 million bond, due 2039, issued by the treasury vehicle GenFinance II.

Rationale

The downgrades reflect our base-case scenario that NHG will increase its exposure to market-related activities over the next three years, in particular outright property sales, resulting in higher industry risk than we typically associate with a traditional social housing provider. We continue to assess NHG's social housing operations as very strong, although its debt service metrics, chiefly the EBITDA interest coverage ratio, are weaker than those of 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, working through the Regulator of Social Housing, in the event of financial distress. Our view is based on our assessment of NHG's important role for the U.K. government and its public policy mandate; and its strong link with the U.K. government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

We continue to consider that NHG benefits from strong economic fundamentals, notably thanks to its presence in London, which is growing faster than the national average. This is where NHG has the majority of its properties (over 85%), and where we see annual population growth of at least 1%. This, in combination with relatively low rents for NHG's social and affordable housing properties compared with the market rent, ensures solid demand for its properties. We also assess that NHG's house prices exceed the national average by about 200%, which further supports our assessment of NHG's enterprise risk profile. We also factor into our assessment of NHG's asset quality the average age of the properties (around 35 years). The solid demand for NHG's properties is further evident from generally low vacancy rates of less than 2%.

In comparison to some of its London-based peers that are expanding outside London, we note that NHG is willing to remain focused on the capital areas where it has built a strong territorial footprint. While this should result in geographical synergies and positively affect NHG's cost structure, we also believe that the relative concentration exposes the group to the housing market downturn that has started to hit London.

NHG's ambitious growth plan following its amalgamation with Notting Hill Housing will lead the group to develop close to 6,000 new homes over the next three years in our base case, of which 15% would be for outright sales and 40% for first-tranche shared-ownership sales. We project that the proportion of NHG's revenues generated from high-risk market-related activities will increase to about 40% in financial year (FY) 2021 from 23% in FY2018, based on this development pipeline. Although we recognize that this is a structural trend in the social housing industry, in our view it elevates risk for NHG by exposing the business to cyclical, and therefore less predictable, revenue sources. We think that NHG's strategy reduces its headroom to withstand external shocks. In addition, we believe that the increased complexity of the business structure has reduced the visibility and predictability of NHG's future earnings, compared with a traditional housing association providing mainly social rent properties.

NHG's plan reflects a broader sector-wide shift toward market-based activities, particularly outright sales and first-tranche shared-ownership sales, which in our opinion elevates risk in the underlying businesses. Unlike traditional rental activities, these market-based activities expose housing associations to the cyclicality in the residential property development sector, and the growth in this sector is less predictable than in social housing due to the significantly higher level of competition.

We have revised upward our assessment of NHG's industry risk as we project that the group will generate more than one-third of its revenues from sales activities by FY2021. Our view is that consumer confidence, disposable income, employment levels, and economic growth, as well as interest rates and the availability of mortgages, will ultimately drive demand for the properties for sale, which heightens NHG's revenue and earnings volatility. Additionally, high variability in sales levels and property valuations, as manifest in recent fluctuations in U.K. housing prices, renders social housing groups vulnerable to business cycle blips.

We project that NHG's S&P Global Ratings-adjusted EBITDA will be consistently below 30%, driven by the shift to low-margin sales activity that is somewhat offset by solid profitability with regard to the general social housing lettings business.

We project that NHG's debt will increase and remain comparatively high, with debt to adjusted EBITDA of about 16x over the FY2019-FY2021 forecast period. NHG will use this debt to fund its large development program over the next three years, along with internally generated cash flows, including proceeds from the sales of new and existing properties. However, NHG's increased involvement in market-related activities will in our opinion lead to social housing EBITDA covering interest payments at just over 1.0x on average over our base case, which is a clear weakness compared with peers, and undermines the group's credit quality.

Liquidity

We consider NHG's liquidity position to be very strong, in part due to its large undrawn committed facilities and cash generated from operations.

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

Sources include:

- Cash flows from operations of close to £210 million;
- Cash and cash equivalents of £150 million;
- Proceeds from asset sales of more than £50 million;
- Available funds under undrawn committed facilities of close to £815 million; and
- An expected cash injection in the form of government grants of £5 million.

Uses include:

- Capital expenditure of more than £540 million; and
- Interest and principal repayments of about £220 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 we expect the amalgamated entity to continue benefiting from strong access to capital markets. We also believe that NHG will be able to maintain substantial headroom under its covenants, and we do not see any risk to its ability to continue to draw on its credit facilities.

Outlook

The negative outlook reflects our view that NHG's rising exposure to property sales may further dent the group's financial performance and raise its debt burden, especially in the event of a negative development in the London real estate market.

We could lower the ratings on NHG over the next two years if NHG's adjusted EBITDA margins were to weaken structurally, or if the group were not able to cover its cash interest payments with revenues from its core social housing lettings business. This could result from further expansion into lower-margin sales activities. Additionally, we could lower the ratings if we revised our assessment of the likelihood of support that NHG receives from the U.K. government through the Regulator of Social Housing.

We could revise the outlook to stable over the next two years if we believed that NHG's strategy and the risks stemming from its exposure to market tenures would not have a further material impact on its EBITDA margins and credit ratios, while at the same time, liquidity remained consistently above 1.25x.

Notting Hill Genesis Key Statistics

	--Year ended March 31--				
(Mil. £)	**2017a**	**2018e**	**2019bc**	**2020bc**	**2021bc**
Number of unites owned or managed	64,871	64,971	62,672	63,837	65,372
Vacancy rates (% of rent net of identifiable service charge)	1.0	1.7	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	2.5	2.3	N.A.	N.A.	N.A.
Revenue§	657.1	686.1	662.8	844.4	922.1
Share of revenue from nontraditional activities (%)	29.9	32.2	27.3	42.1	44.8
EBITDA†	209.8	196.4	193.2	239.9	264.1
EBITDA/revenue (%)	31.9	28.6	29.1	28.4	28.6
Interest expense	124.0	134.2	138.0	145.8	151.1
Debt/EBITDA (x)	13.7	16.6	18.2	15.6	14.4
EBITDA/interest coverage** (x)	1.7	1.5	1.4	1.6	1.7
Capital expense	303.4	408.0	563.9	400.2	280.3
Debt	2,869.2	3,267.6	3,520.1	3,731.1	3,803.6
Housing properties (according to balance sheet valuation)	6,284.9	6,487.7	6,970.2	7,286.8	7,482.4
Loan to value of properties (%)	45.7	50.4	50.5	51.2	50.8

Notting Hill Genesis Key Statistics (cont.)

	--Year ended March 31--				
(Mil. £)	**2017a**	**2018e**	**2019bc**	**2020bc**	**2021bc**
Cash and liquid assets	157.5	200.7	40.4	40.4	40.4

*Rent and service charge arrears. §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.

Notting Hill Genesis Ratings Score Snapshot

Industry Risk	3
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
Liquidity	2
Financial policies	3
Financial profile	4

S&P Global Ratings' analysis of social housing providers' creditworthiness rests on our scoring of eight key rating factors: (i) industry risk; (ii) economic fundamentals and market dependencies; (iii) strategy and management; (iv) asset quality; (v) financial performance; (vi) debt profile; (vii) liquidity; and (viii) financial policies. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published Dec. 17, 2014, and "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015, detail how we derive and combine the scores, and then determine each social housing provider's stand-alone credit profile and the issuer credit rating. In accordance with S&P Global Ratings'public and nonprofit social housing providers methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating, the committee can make use of the flexibility afforded by paragraphs 12-17 of "Methodology For Rating Public And Nonprofit Social Housing Providers."

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
- Criteria - Corporates - Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 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

- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018

- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 27, 2018
- U.K. Social Housing Providers To Borrow £12 Billion Of New Debt By 2020, Total Debt To Reach £89 Billion, March 7, 2018
- New Rent Policy Brings Relief, But No Big Boost To The Credit Standing Of U.K. Housing Associations, Jan. 31, 2018
- Global Social Housing Risk Indicators, Jan. 30, 2018
- U.K. Social Housing Scenario Analysis: What Could Happen To Ratings In A Market Downturn?, Sept. 25, 2017

Ratings List

Downgraded

	To	From
Notting Hill Genesis		
Notting Hill Home Ownership Ltd.		
Issuer Credit Rating	A/Negative/--	A+/Negative/--
GenFinance II PLC		
Senior Secured	A	A+
Notting Hill Housing Trust		
Senior Secured	A	A+

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.