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Research Update:

U.K.-Based Housing Provider Notting Hill Genesis Assigned 'A+' Ratings After Completed Amalgamation; Outlook Negative

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Overview

- The amalgamation of housing associations Genesis and Notting Hill Housing has created Notting Hill Genesis (NHG). We are therefore discontinuing our ratings on Genesis and Notting Hill Housing.
- Our view of NHG's creditworthiness balances the housing organization's operations in a low-risk industry with high demand against the projected increase in market-related activities that exposes the group to high earnings volatility.
- We also factor in our opinion that there is a moderately high likelihood that the U.K. government will provide extraordinary support to NHG if needed.
- We are assigning NHG our 'A+' long-term issuer credit rating.
- The negative outlook on NHG reflects that on the U.K.

Rating Action

On April 3, 2018, S&P Global Ratings assigned its 'A+' long-term issuer credit rating to London-based housing association Notting Hill Genesis (NHG). The outlook is negative.

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

We also affirmed our 'A+' issue credit ratings on NHG's four bonds (£250 million due 2032, £300 million due 2042, £400 million due 2048, and £250 million due 2054), previously issued by Notting Hill Housing. In addition, we raised to 'A+' from 'A-' our issue rating on the £250 million bond, due 2039, issued by the treasury vehicle GenFinance II. We removed the rating on GenFinance II's bond from CreditWatch with positive implications, where we placed it on Feb. 22, 2018.

Finally, we discontinued our 'A-' ratings on Genesis Housing Association and 'A+' ratings on Notting Hill Housing Trust.

Rationale

Our 'A+' rating on NHG is one notch higher than our 'a' assessment of its stand-alone credit profile. This reflects our opinion that there is a moderately high likelihood that the U.K. government--working through the Regulator of Social Housing (RSH)--would provide timely and sufficient extraordinary support to NHG in the event of financial distress.

South East England, where NHG enjoys a high-quality asset base, notably in London, offers solid economic fundamentals, low industry risk, and robust financial policies, all of which support NHG's credit profile. However, NHG's increasing volume of market-related activities and the group's significant development program, in our view, have elevated risks linked to earnings volatility and a materially higher debt burden.

NHG's development plan, compared with the strategies of Notting Hill Housing and Genesis as separate entities, represents a marked change that, in our view, could present execution challenges and expose the business to real estate market forces. The group's plan includes the construction of 2,500 units annually through March 2023, with a focus on shared ownership that will form over 35% of the total build with a further 20% built for outright sales. Although we think that management, comprising the best talent from Genesis and Notting Hill Housing, is competent and has the skills to grow at such a scale, we consider the overall program to be aggressive and that it will expose the business to more cyclical risk from the housing market. Given NHG's size, we anticipate that it would show greater resilience in a pronounced downturn in the housing market than the previously separate entities.

The traditional social housing industry continues to exhibit low risk globally, based on limited exposure to business cycles and less competition from non-government-related providers. The industry enjoys strong demand and is consistently high on the political agenda. That said, NHG also engages in non-traditional activities, including shared ownership and open market sales, that are more exposed to market volatility and, in particular, to potential adverse reversals in the U.K. property market.

NHG generated about 30% of its revenues from non-traditional activities in fiscal 2017 (ended March 31, 2017). In our base case, we estimate that revenues from non-traditional sources will rise to just over one-half of revenues by the end of fiscal 2020, largely driven by an increase in development of housing for sale to 29% of total revenues in 2020 from 13% in 2017. These activities exhibit riskier fundamentals than traditional social housing activities and could experience an acute drop in valuations during a housing market downturn.

The majority of NHG's assets (nearly 90% of housing stock) are located in London boroughs, including Barnet, Hammersmith & Fulham, Kensington & Chelsea, and Westminster, and the remaining share is spread across the economically dynamic regions of Essex and Surrey in the south of England. These areas exhibit above-average economic fundamentals, such as growing populations and low unemployment, which support a high demand for housing. We expect the population to grow by slightly more than 1% annually, and social rent to be somewhat over 40% of prevailing market rents.

We consider the caliber of NHG's housing assets to be a rating strength. The group's stock portfolio is fully compliant with the U.K. government's Decent Homes Standard and has an average age of 35 years. While tenant arrears are expected to be about 5%, we anticipate that this will lower over time, factoring in the roll out of universal credit, and the revised benefits system that combines support for unemployment, tax credits, and housing, among others. A high-quality asset base, alongside strong and rising housing demand and low social rents compared with market rents in the region, has enabled NHG to keep vacancy rates below 2% of net rent receivables and therefore support the group's very strong enterprise profile assessment.

NHG's revenues are likely to increase dramatically over our forecast period, to £1,014 million in fiscal 2020 from £676 million in fiscal 2017, in line with the group's sizable development program. However, we believe that NHG's EBITDA margins will remain near 30% and show increased volatility due to the heightened exposure to market-related activities.

Compared with the previously separate housing companies, NHG has a higher tolerance to using debt to achieve development goals in line with its relatively large asset base. We expect the group's debt to EBITDA to peak at a relatively high 17x in fiscal 2018, before reducing to 13x by fiscal 2020. A combination of more volatile cash flows from market-related activities and higher debt service requirements could expose the group to greater risk. Of the current £2,869 million of S&P Global Ratings-adjusted total debt, 76% has a fixed rate with an average interest rate of 3.87%. The group has sufficient EBITDA interest coverage of 1.8x on average. Furthermore, it has a smooth debt maturity profile, and derivatives are only used for treasury purposes. We note positively that the group can also cover interest costs from social housing lettings income over our three-year base case (2018-2020).

We base our view on the likelihood of extraordinary government support on NHG's important role for the U.K. government and its public-policy mandate, and its strong link with the government. The U.K. government has a track record of providing extraordinary support to the housing sector.

Liquidity

We consider NHG to have strong liquidity, thanks to its very high level of undrawn credit facilities and large amount of cash and liquid assets. In our base case over the next 12 months, we estimate that liquidity sources will cover uses by about 1.4x.

Our estimate of the group's principal liquidity sources include:
- Adjusted EBITDA of about £268 million;

- Undrawn credit facilities of approximately £702 million;
- Cash and liquid assets of about £178 million;
- Proceeds from asset sales exceeding £66 million; and
- Government grants and other sources £122 million.

We estimate the following principal liquidity uses:

- Capital expenditures of about £697 million; and
- Debt service (including interest costs) of about £240 million.

Outlook

The negative outlook reflects that on the U.K. We could lower the rating if we downgraded the U.K. in the near future or if we saw the link between the government and NHG weaken over time.

We could revise the outlook to stable over the next 24 months if we revised the outlook on the U.K. to stable and if we observed stabilizing financial performance with adjusted EBITDA standing above 30%, contained leverage, and robust liquidity, all else remaining equal.

Table 1

Notting Hill Genesis Key Statistics

	--Year ended March 31--				
(Mil. £)	**2016a**	**2017a**	**2018bc**	**2019bc**	**2020bc**
Number of units owned or managed	62,979	63,935	64,275	65,852	67,425
Vacancy rates (% of rent net of identifiable service charge)	1.0	1.7	1.0-2.0	1.0-2.0	1.0-2.0
Arrears (% of rent net of identifiable service charge)*	5.0	5.0	N.A.	N.A.	N.A.
Revenue§	728.3	657.1	689.9	901.0	1,005.9
Share of revenue from non-traditional activities (%)	38.0	31.5	36.2	49.2	52.3
EBITDA†	224.4	209.8	194.4	268.4	323.9
EBITDA/revenue (%)	30.8	31.9	28.2	29.8	32.2
Interest expense	128.7	124	123.3	141.8	160.2
Debt/EBITDA (x)	12.5	13.7	16.9	14.1	13.0
EBITDA/interest coverage‡ (x)	1.7	1.7	1.6	1.9	2.0
Capital expenditures	205.0	303.4	696.7	697.5	633.4
Debt	2,793.8	2,869.2	3,294.2	3,793.9	4,197.6
Housing properties (according to balance sheet valuation)	6,126.2	6,284.9	6,895.9	7,507.7	8,051.2
Loan to value of properties (%)	45.6	45.7	47.8	50.5	52.1
Cash and liquid assets	230.4	157.5	25.3	20.0	20.0

*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.

Table 2

Notting Hill Genesis Ratings Score Snapshot	
Industry risk	2
Economic fundamentals and market dependencies	2
Strategy and management	3
Asset quality and operational performance	1
Enterprise profile	2
Financial performance	4
Debt profile	3
Liquidity	3
Financial policies	2
Financial profile	3

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
- 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

- Genesis Housing Association Rating Kept On Watch Positive Pending Completion Of Merger With Notting Hill Housing Trust, Jan. 18, 2018
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, Oct. 27, 2017
- Notting Hill Housing Trust Affirmed at 'A+'; Outlook Remains Negative, Sept. 15, 2017

Ratings List

New Rating

Notting Hill Genesis		
Issuer Credit Rating	A+/Negative/--	

Ratings Affirmed

Notting Hill Home Ownership Ltd.		
Issuer Credit Rating	A+/Negative/--	
Notting Hill Genesis		
Senior Secured	A+	

Upgraded; CreditWatch Action

	To	From
GenFinance II PLC		
Senior Secured	A+	A-/Watch Pos

Ratings Discontinued

	To	From
Genesis Housing Association		
Issuer Credit Rating	NR	A-/Watch Pos/--
Notting Hill Housing Trust		
Issuer Credit Rating	NR	A+/Negative/--

NR--Not rated.

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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 the 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.