

Research Update:

# U.K.-Based Housing 21 Downgraded To 'A' Due To Weaker Financial Performance; Outlook Stable

July 24, 2019

## Overview

- In our view, an increase in capital repairs and a continued inclusion of shared-ownership property sales in the company's strategy will reduce and weaken the quality of earnings for Housing 21 (H21).
- While demand remains strong in H21's niche older persons and care sector, its exposure to care services results in low margins.
- We are therefore lowering our long-term issuer credit rating on H21 to 'A' from 'A+'.
- The stable outlook reflects our view that demand will remain very strong for H21's offerings.

## Rating Action

On July 24, 2019, S&P Global Ratings lowered its long-term issuer credit rating on Housing 21 (H21) to 'A' from 'A+'. The outlook is stable.

We also lowered our issue rating on H21's £250 million senior secured bond to 'A' from 'A+'.

## Rationale

The downgrade reflects our expectation that an increase in capitalized repairs and exposure to sales will weaken H21's already-low S&P Global Ratings-adjusted EBITDA margins. H21's care services already generate earnings of a low quality and the group's decision to retain shared-ownership property sales in its strategy will exacerbate this. Furthermore, we forecast that an increase in capitalized repairs will keep margins below 20% on average throughout our base-case period of 2018-2022. In our view, weaker financial performance underpins a weaker financial profile.

Our rating on H21 is one notch higher than its stand-alone credit profile. The one notch difference is based on 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 H21 in the event of financial distress. In our view, H21, like

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other housing associations in England, has an important role in providing housing and a strong link with the RSH. We base this view on H21's important role for the U.K. government and its public policy mandate, and its strong link with the U.K. government, as demonstrated by the government's track record of providing strong credit support to the sector in times of need.

H21's rating strengths remain in its enterprise profile, which is supported by strong demand, its strategy, and its improving asset quality and operational performance. In our view, H21's focus on tenants aged 65 years old and above results in strong demand for its services. England has a rapidly ageing population, with the Office of National Statistics forecasting growth in people over 60 years old of nearly 2% until 2029. In our opinion, this strong growth in H21's target customer base will support demand. Additionally, H21's nationwide reach, where on average social housing rents are generally less than 70% of market rents, supports demand.

Operationally, H21 has continued to work on reducing the level of voids, which had historically been higher than that of peers. Overall, the void rate fell to 1.8% of the total rent and service charge receivable for the fiscal year (FY) ending March 31, 2019, from 2% in FY2018. Regarding arrears, H21 continues to record low arrears of 1.8% in FY2019, which is lower than the arrears of most rated peers. We view positively management's efforts to improve operationally and we now look for a track record in keeping void rates sustainably below 2%.

H21's development plan has changed again for 2019. Last year, H21 extended its delivery date of 2,300 units to FY2022 from FY2021. Now, in 2019, the number of developed units between FY2020 and FY2022 is nearly 200 less than what was set out in 2018. Management also believes that H21 can complete 1,000 units per year from FY2022, which is 200 units higher than the 2018 plan. H21 has not achieved completions on this scale within the last three years, therefore we believe that the development plan is ambitious. To reflect this, we have applied haircuts to management's plan for units due to be completed in FY2021 and FY2022. We view frequent changes to H21's development plan as unfavorable, as this results in volatility in H21's projected cash. However, we view positively the group's decision to remove nearly all outright sales from its development plan.

H21 recorded just 11 shared-ownership property sales in FY2019. This was lower than our projection of 91 and we now expect the remaining sales to take place in FY2020. With haircuts in place, we forecast that H21 will achieve 600 shared-ownership property sales between FY2020 and FY2022. The removal of outright sales from our projections this year, combined with a haircut on shared-ownership property sales, results in lower projected EBITDA. In addition, we forecast that adjusted EBITDA will be lower due to an increase in capitalized repairs. H21 is bringing forward works to digitalize its emergency call systems in its retirement and extra care properties, which will increase capitalized repairs over the short term. We therefore expect weaker adjusted EBITDA margins in our base case compared to last year, averaging 17.8%, down from 20.0%.

Our forecast of lower EBITDA will result in an increased need for debt to fund H21's development program. We expect debt to increase and peak at £626.4 million in FY2022. Underpinning this increase in debt is the group's policy to ensure it has £100 million of cash and facilities available at all times. Leverage remains high in FY2019, with debt to EBITDA at nearly 20x, and we expect a similar metric for FY2020, before it gradually falls to 13x in FY2022. Consequently, we expect EBITDA interest coverage to be tight in FY2020, at 1.1x, before improving to 1.8x in FY2022. Our projected increase in EBITDA from aspirational sales and increased rental stock supports these debt profile metrics. Should H21 prove unsuccessful in achieving its development and sale aspirations, we could see pressure on these metrics.

Our assessment of H21's financial policies has weakened in line with our overall view of its weaker financial profile. The changes in H21's development plan and capitalized repairs program result in less predictable and volatile earnings in H21's financial profile. We also forecast that EBITDA interest coverage from non-sales activities falls to just 1x in FY2020, which in our opinion is not

consistent with prudent financial policies.

## Liquidity

H21's liquidity position has deteriorated from last year, but remains a rating strength. H21's liquidity sources are supported largely by £215 million of cash generated through a bond issuance. We forecast that liquidity sources will cover uses by 2x over the next 12 months. However, we could see this coverage weaken in line with a peak in H21's capital expenditure (capex) program due in FY2021.

Sources of liquidity include:

- Adjusted EBITDA as a cash flow proxy of £33 million;
- Cash and liquid investments of £215 million;
- Undrawn committed bank facilities of £25 million; and
- Proceeds from asset sales of £7 million.

Uses of liquidity include:

- Our expectation of adjusted capex of £94 million; and
- Interest and principal payable of £44 million.

We continue to view H21's access to external liquidity as satisfactory.

## Outlook

The stable outlook reflects our view that demand will remain strong for H21's service offerings. It also reflects our expectation that management will maintain its current strategy, continuing to focus on the development of housing for older people. Finally, the stable outlook reflects our opinion that H21 will perform in line with our base case, ensuring that EBITDA interest coverage does not fall below 1x.

We could lower the rating on H21 over the next 24 months should management change the current strategy to one that exposes the group to more risk. In particular, a shift in strategy to one focusing on outright sales could result in us changing our assessment of H21's strategy, which at present remains a rating strength.

We could raise the rating on H21 if we saw a sustained improvement in financial performance. We would expect to see the adjusted EBITDA margins improving structurally to above 20%. At the same time, we would expect to see exposure to sales-related activities remain low, such that sales receipts did not account for over 15% of revenues.

## Key Statistics

### Housing 21 Selected Financial Indicators

(Mil. £)	--Year ended March 31--				
	2018a	2019e	2020bc	2021bc	2022bc
Number of units owned or managed	20,188	21,009	21,209	21,750	22,460

## Housing 21 Selected Financial Indicators (cont.)

(Mil. £)	--Year ended March 31--				
	2018a	2019e	2020bc	2021bc	2022bc
Vacancy rates* (%)	2.0	1.8	N.A.	N.A.	N.A.
Arrears* (%)	1.8	1.8	N.A.	N.A.	N.A.
Revenue§	178.5	186.1	195.7	216.2	234.5
Share of revenue from nontraditional activities (%)	20.2	21.2	24.0	28.1	29.6
EBITDA§†	34.7	30.6	29.8	38.2	47.1
EBITDA/revenue §† (%)	19.4	16.4	15.2	17.7	20.1
Interest expense‡	24.1	27.0	26.7	26.2	27.6
Debt/EBITDA §† (x)	18.0	19.7	19.1	15.4	13.3
EBITDA/interest coverage§†‡ (x)	1.4	1.1	1.1	1.5	1.7
Capital expense†	30.0	31.8	80.0	123.4	84.1
Debt	622.4	602.1	570.2	588.3	626.4
Housing properties (according to balance sheet valuation)	1,116.1	1,147.2	N.A.	N.A.	N.A.
Loan to value of properties (%)	55.8	52.5	N.A.	N.A.	N.A.
Cash and liquid assets	238.8	215.1	144.7	75.0	75.0

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

## Ratings Score Snapshot

### Housing 21 Ratings Score Snapshot

Industry risk	2
Economic fundamentals and market dependencies	2
Strategy and management	2
Asset quality and operational performance	2
Enterprise profile	2
Financial performance	5
Debt profile	3
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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Downgraded

	To	From
<b>Housing 21</b>		
Issuer Credit Rating	A/Stable/--	A+/Negative/--
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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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.

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