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Research Update:

Notting Hill Housing Downgraded To 'A+' On Weakening Financial Profile; Outlook Negative On Heightened Sales Risk

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Table Of Contents

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Overview

- We now believe that Notting Hill Housing Trust (Notting Hill) has a strong financial profile, whereas previously we assessed it as very strong.
- We are therefore lowering our long-term issuer credit rating on Notting Hill by one notch to 'A+' from 'AA-'.
- The negative outlook reflects our view that there is a one-in-three possibility of a downgrade over the next two years if Notting Hill's strategy continues to elevate the risk profile of the entity, by increasing the weight of market-related activities in an environment of heightened sale risk. In this case, we could revise downward our assessment of the group's financial profile and of its management.

Rating Action

On Oct. 4, 2016, S&P Global Ratings lowered to 'A+' from 'AA-' its long-term issuer credit rating on U.K. social housing provider Notting Hill Housing Trust. The outlook is negative.

At the same time, we lowered to 'A+' from 'AA-' our long-term issuer credit rating on its subsidiary, Notting Hill Home Ownership (NHHO). NHHO is focusing on developing and managing shared ownership properties in London. We view NHHO as having a core group status within the Notting Hill Housing Group, and hence we equalize its rating with its parent, Notting Hill Housing Trust.

Rationale

The downgrade reflects our view that Notting Hill’s financial profile will structurally deteriorate over the next years, on the basis of much higher debt and having less liquidity to finance the group’s significant development program in the London area.

The 'A+' long-term issuer credit rating on Notting Hill is based on its stand-alone credit profile (SACP), which we now assess at 'a+'. We also continue to expect a moderately high likelihood of Notting Hill receiving extraordinary support from the U.K. government, working through the Homes and Communities Agency (HCA), which has a neutral effect on the ratings.

We base our view of the likelihood of extraordinary government support on Notting Hill's important public policy role for the U.K. government, and its strong link with the U.K. government through the funding and regulation provided by the Greater London Authority and the HCA.

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Notting Hill's SACP, which we assess on a consolidated group level, is still supported by its very strong enterprise profile. Notting Hill is one of London's major housing associations, with about 32,000 units under management as of fiscal year end 2016, and benefits from the high demand for social housing in its operations areas. We also factor in Notting Hill’s strong management with a good track record of substantially improving its financial performance over the past years. That said, in our view Notting Hill is showing a large appetite for risk through development-for-sale schemes. Operational performance is good in terms of voids (1.3% recorded over 2012-2016), although arrears remain relatively high compared with Notting Hill’s peer group in the G15 (London's 15 largest housing associations). However, we acknowledge efficient work realized by Notting Hill’s management to gradually reduce late payments over the past few years.

In our 2016 updated base-case scenario, we view Notting Hill's financial profile as strong, whereas we viewed it as very strong previously. Notting Hill’s strategy has enabled the group to improve adjusted EBITDA margins substantially over the past years (from 15% in 2010 to 41% in 2016), but we now foresee a gradual decrease in adjusted EBITDA margins in our 2017-2019 base case (36% per year on average), lower than our October 2015 forecast (40%). While we continue to assume growth in revenue stemming from lettings and market sales, we now foresee a substantial increase in property development costs through 2019 that will weigh on adjusted EBITDA margins.

Notting Hill has an ambitious capital program concentrated in London and plans to develop approximately 6,800 homes over the next five years. Shared ownership will be the main development program (around 35%) and the rest will be split across private sale (20%), market rent (25%), and affordable rent (20%). We continue to factor in Notting Hill’s financial profile its substantial exposure to market-driven activities as open market sales will account for about 40% of Notting Hill turnover in our 2019 base case scenario. As a result of the U.K. central government welfare reform, rent cuts will start to weaken housing associations' financial profiles in fiscal year 2017. We believe that Notting Hill will remain relatively immune from the rental reduction as more than 50% of revenue will stem from non-traditional activities during our forecast horizon.

Given Notting Hill’s large development program, we now anticipate a substantial debt increase in the next few years (to about £1.9 billion in FY2019 from £1.3 billion in FY2016), and we forecast adjusted debt to EBITDA at more than 10x in our updated 2018-2019 base-case scenario (from less than 8x in FY2016), with interest coverage to fall below 2.5x in the same period. That said, Notting Hill still benefits, in our view, from high levels of unencumbered security, with a potential value (EUV-SH) of more than 50% of debt outstanding as of September 2016.

Liquidity

We now assess Notting Hill as having a very strong liquidity position, whereas we viewed it as excellent beforehand. We foresee Notting Hill's existing sources of liquidity will exceed its expected uses over the next 12 months by 1.8x (from 2.2x previously). This results from lower available resources from liquidity facilities and asset sales, as well as a projected debt capital repayment of £10 million over the next 12 months.

Given Notting Hill's track record of accessing the capital markets since 2011 and securing low margins relative to the sector, we continue to view the group's access to external liquidity as strong.

Outlook

The negative outlook reflects our view that there is a one-in-three possibility of a downgrade over the next two years if Notting Hill's strategy continues to elevate the risk profile of the entity, by increasing the weight of market-related activities in an environment of heightened sales risk. In this case, we could revise downward our assessment of the group's financial profile and of its management.

We would revise the outlook to stable if we believed that Notting Hill’s strategy and risk stemming from exposure to market tenures was not going to have a material impact on its credit ratios.

Key Statistics

Notting Hill Housing Trust Financial Statistics

	--Fiscal year ending March 31st--				
('000. £)	**2015a**	**2016a**	**2017bc**	**2018bc**	**2019bc**
Number of units	30,613	31,830	32,647	33,222	34,339
Vacancy rates (% of net rental income)	1.1	1.2	0.0	0.0	0.0
Arrears (% of net rental income)*	5.0	5.7	0.0	0.0	0.0
Revenue	402,800	415,400	416,127	390,741	554,522
Share of revenue from non-traditional activities (%)	50.4	48.2	48.4	42.9	58.2
Operating expense	258,900	272,700	276,724	268,861	403,073
EBITDA§	167,400	169,300	162,413	145,332	176,712
EBITDA/revenue (%)	41.6	40.8	39.0	37.2	31.9
Interest expense	56,300	58,000	59,166	66,106	75,604
Debt/EBITDA (x)	7.5	7.7	9.0	11.2	10.8
EBITDA/interest coverage (x)†	3.0	2.9	2.7	2.2	2.3
Capital expense	243,000	169,400	290,207	253,088	353,100
Debt	1,252,400	1,297,600	1,460,401	1,622,353	1,904,273
Housing properties (according to balance-sheet valuation)	2,940,400	3,034,300	3,310,634	3,444,972	3,614,060
Loan to value of properties (%)	42.6	42.8	44.1	47.1	52.7
Cash and liquid assets	45,700	80,900	50,422	15,180	0

*Current arrears §Adjusted for capitalized repairs. †Including capitalized interest. a--Actual e--Estimate bc--Base case reflects Standard & Poor's expectations of the most likely scenario

Related Criteria And Research

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 - December 17, 2014
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Notting Hill Housing Trust Long-Term Rating Lowered To 'AA-' Following Downgrade Of United Kingdom; Outlook Now Stable, July 4, 2016

Ratings List

	Rating	
	To	From
Notting Hill Housing Trust		
Issuer Credit Rating		
Foreign and Local Currency	A+/Negative/--	AA-/Stable/--
Notting Hill Home Ownership Ltd.		
Issuer Credit Rating		
Foreign and Local Currency	A+/Negative/--	AA-/Stable/--

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.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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.

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