Article Title: ARCHIVE | Criteria | Governments | International Public Finance: Rating Public and Social Housing Providers Data: (Editor's Note: This article has been superseded by "Credit Approach to Rating Public and Social Housing Providers," published on Oct. 10, 2002. In the article published on Sept. 28, 2000, the second chart, "Estate Risk Characteristics," was omitted. A corrected version of the article follows.) The universe of rated public and social housing providers continues to grow rapidly, and Standard & Poor's now has public housing-related ratings in countries as diverse as the U.K., Sweden, New Zealand, The Netherlands, Australia, and the U.S. The reasons for obtaining a rating vary. For many public housing providers that have moved from being primarily government assisted to having private and public ownership and funding structures, Standard & Poor's ratings have helped improve access to financial markets. Other public housing providers have used ratings to help establish and distinguish themselves with a variety of stakeholders. Irrespective of why a rating is sought, the Standard & Poor's rating process is not limited to the examination of various financial ratios. An accurate assessment of a public housing provider's creditworthiness requires a broader framework that also focuses on interrelating factors such as the demand and marketplace for its housing; asset base quality; operational performance; and the impact of governmental and regulatory policy (see chart 1). This general framework takes into account the distinct characteristics of the rated housing entity's environment, as well as its location, ownership, focus and finances, while allowing for an international comparison despite often major differences. 1 Demand and Affordability Fundamental to the credit quality of public sector landlords is their ability to attract tenants or buyers for their properties at revenue levels that allow them to meet their debt and operating commitments as well as allowing them to invest in their property. The relationship between national demand and supply for public and social housing varies from country to country. For example, national housing supply generally equates with demand in The Netherlands, while considerable additional social housing is needed in the U.K. to meet demand. Nevertheless, the national situation provides only a very broad indication of housing demand for most individual housing providers. This is because there are few truly national public housing providers such as Housing New Zealand Ltd. (A+/Positive/A-1) and demand is always ultimately driven by local market conditions. Therefore, when assigning a credit rating to an individual public housing provider, Standard & Poor's undertakes a detailed analysis of local market conditions. Local market conditions are determined by a number of different characteristics including: Local economy; Population and demographic trends; and The competitive position of the public housing provider. Local economy. The economic base and growth prospects of a housing provider's region or locality have a significant impact on long-term public housing demand. A strong and diverse local economy with relatively low unemployment, high investment levels, and good infrastructure and transport links will generally support a stable or growing population as well as asset prices. While rents rather than asset sales dominate the revenue streams for most public housing providers, low or declining local house prices still provide a clear indication of oversupply within the general housing market, as well as highlighting concerns over the area's residential attractiveness. If house prices fall too low, buying can represent a realistic alternative to public housing for many tenants, and properties can sometimes be bought at very low prices by private landlords who subsequently charge low rents compared with the established social housing provider. Local economy growth prospects are also important in establishing long-term housing demand. Standard & Poor's will evaluate the local economy's outlook based on recent trends in employment, output, and investment, adjusted for any recent structural and policy changes. Another important factor is the extent to which the cyclicality of economic conditions impacts on demand for the social housing provider's housing. As some public housing providers have high exposure to market rents and asset sales, their income levels will be relatively sensitive to economic cycles. For other social housing providers, below market rent levels and the important role of the government housing rent subsidy to tenants help smooth cyclicality of demand relating to general economic conditions. Population trends. Stable or growing populations are the bedrock of long-term demand. Structural changes in the economies of many industrial European cities, such as those in the north of England, have led to significant population declines which, over time, have reduced demand for housing in those areas. Much of the population migration has been toward more service-oriented conurbations that have experienced increased demand for new housing. The age distribution of the population is also important, particularly if it is changing, as this often leads to different housing needs.

Standard & Poor's will therefore analyze how the type and nature of the housing provider's property portfolio meets the changing demands of the local population. Competitive position. Standard & Poor's focuses on various factors when assessing the competitive position of the public housing provider. High local market share can often be an important strength for some housing providers. Swedish local housing companies, for example, generally dominate their local housing market, as they often provide 50% of total available rented housing within a city and their rent levels are used as a benchmark for rental setting in the private rental housing sector. For other types of public housing providers Standard & Poor's will assess the extent, quality, and rent levels of large alternative public housing providers within the area, as well as the affordability and quality of alternative accommodation, whether it be rented or privately owned. Finally, voids and property turnaround times, the length of any waiting lists, the housing provider's lettings policy, and the number of housing offers rejected by potential tenants are assessed. As housing is very much a local market, geographical diversity can help reduce exposure to local problems. A diversified tenant base can also help improve credit strength and long-term housing demand. In countries such as The Netherlands, housing associations have a relatively broad tenant base. In the U.K. and the U.S., however, the socioeconomic profile of association tenants has continued to narrow, leading to greater social polarization and the loss of tenants from traditional client groups to other sectors. In some areas this has increased problems relating to the lettability of stock, leading to difficulty in creating sustainable mixed-income communities and intensified housing management operational issues. One growing trend that can often help improve geographical diversity, increase financial strength, and provide greater economies of scale, is that of mergers between individual housing providers. Although some mergers can improve credit quality, Standard & Poor's still looks for a clear strategy behind the merger rather than just a desire for growth. There are also considerable cultural differences between housing providers that need to be overcome and significant increases in the scope of activities can create control and performance issues if not correctly managed. Also, some mergers are driven by financial problems in one of the entities. These must be resolved as part of the merger process in order that they are not simply replicated within the new larger provider. Asset Quality Standard & Poor's has no minimum size criterion for public housing providers at any given rating level, although the number of units owned by a housing provider often provides a measure of diversification as well as other credit benefits. Instead, when reviewing the asset base of a public housing provider, Standard & Poor's focuses on: The nature and standard of property owned by the public housing provider; and The approach and key strategy drivers of the association, whether it be in developing new property, undertaking urban regeneration projects, or managing its existing property portfolio. Existing property portfolios. When reviewing the existing property portfolio, Standard & Poor's considers its type, age, and quality. Many housing providers have diverse property portfolios that include flats and different house types that need to be assessed in terms of the local demographics and composition of the wider housing market. These property portfolios may be used for a variety of purposes, including general social lettings, commercial lettings, special needs, and market rent, with each use having its own risk profile. For example, lower government capital subsidies have prompted many housing providers to diversify into new areas to maintain growth or generate additional surpluses. Many of these new areas are other 'bricks and mortar' accommodation businesses such as student accommodation where the housing provider can still apply its existing housing development and management skills to help offset some of the newer risks. Some areas that housing developers are diversifying into are, however, more traditionally associated with the private sector such as build-for-sale, market rent, or nursing home provision. The skill set required to succeed in these areas can differ from the core general renting needs and the level of risk associated with these areas often is higher owing to the developers operating in fragmented but competitive and volatile private-sector markets. As a result, Standard & Poor's analyzes each type of property/business separately and forms a composite from these building blocks, weighting each element according to its importance to the overall organization. The age and quality of the portfolio also plays an important role in the creditworthiness of a housing provider. A well-maintained portfolio reduces immediate financial and operational pressures facing the housing provider and influences the long-term viability or curb appeal of the assets. The overall maintenance and condition of the portfolio is therefore assessed, partly through site visits but also by understanding the housing provider's maintenance and major repair programs and procedures. Where asset disposals, demolitions, or reconfigurations have occurred, the scale and reasons are examined to assess whether they indicate normal portfolio management or more significant underlying problems. New Housing Development and Regeneration Many public housing providers are significant developers of new property. In general, the extent to which new development programs impact on a housing provider's risk profile depends on the scale of development, the robustness of approach, and how the housing provider's overall finances are affected. Several important factors determine the size of the development program. Some form of new property development can often help improve the risk profile of a housing provider by increasing asset diversification and positively changing the average age and profile of the property stock. Large-scale development programs generally increase risk, however, as they usually entail additional debt, involve considerable operational resources, and inevitably contain some unproven assumptions relating to demand and/or costs. When reviewing how a housing provider approaches its development program, Standard & Poor's pays particular attention to the appraisal process. Assessment of the housing needs and local infrastructure supporting the new development is as important as the financial appraisal, the best of which are based on conservative assumptions and include some form of breakeven analysis and discounted cash flow review. Also, while it is inevitably reassuring that an organization is undertaking positive net present value projects, new developments should not be considered in isolation. Many positive net present value projects still generate considerable net cash outflows in their early years. Therefore, the impact of successive large new development programs on the providers' short- and medium-term finances, as well as the levels of new debt that will be required, need to be carefully modeled, and are important considerations in any rating. Assessing Estate-Specific Business Risks As well as rating individual housing providers, Standard & Poor's has been asked to rate individual housing projects, estates, or units. In undertaking this work, Standard & Poor's focuses on a number of key factors when analyzing the business-related risks associated with individual public housing estates. Even the best public housing estates are unlikely to be strong in all assessment areas. Nevertheless, it is important to assess the varying exposures to high risk, and a good balance between the different factors should provide a strong indication of long-term demand. Management experience and quality is vital, with the better management actively involving the tenants in order to increase the sense of ownership and estate identity. Obviously, the better the project is in terms of accessibility, configuration, and standards, the lower the risk of maintenance liabilities and of being able to attract sufficient tenants. Where the estate is being significantly reconstructed, the new design will be of paramount importance, especially if past mistakes are to be avoided. Rent levels will also be important and often need to be increased to help fund capital improvements. If rents are too high compared with nearby housing and the relative incomes of tenants, however, it will prove difficult to attract tenants and the flexibility to raise rents in times of financial difficulty will be reduced. The available local supply of comparable social housing also needs to be considered, with other types of housing often important in helping to ensure sustainable communities and long-term demand. Another factor common to many long-term problem estates is that they are often very isolated because of inadequate transport infrastructure and poor local services such as schools, shops, and health centers. Ultimately, the strength of the local economy and population trends will strongly influence long-term demand. Sometimes, the estates are part of an urban regeneration project and are intended to replace poor-quality housing. Although this can bring wider benefits to the area, it will not, by itself, achieve long-term sustainable improvements. Of equal importance to physical renewal, are the economic improvement and social revitalization of the area, and these aspects of urban regeneration are often the hardest to achieve. Public housing providers also play an important role in the significant efforts being undertaken to rejuvenate cities in many countries. These urban regeneration projects, which often involve a significant investment backlog and considerable social problems, give housing providers the opportunity to leverage their development and housing management skills. If these projects are to be successful, however, the emphasis will need to be on establishing effective partnerships with other bodies such as employment agencies, and local business and tenant groups to ensure that the estates' socioeconomic and physical problems are tackled. Standard & Poor's also will assess whether the housing providers have taken on too many 'problem' estates and are running the risk of unbalancing their overall property portfolio (see box and chart 2 on assessing specific estate risk).

com.spglobal.ratings.services.article.services.xsd.Object@7567882b 2 Governmental Support and Regulatory Framework Government bodies play an important role in shaping the environment within which the social housing company operates. Their influence on credit quality takes many forms, including ownership, public policy and support, regulatory behavior, and rental constraints. Ownership. Most public housing providers rated by Standard & Poor's are either independent not-for-profit organizations or are state or local government-owned. A state- or local government-owned housing provider does not intrinsically carry the same level of credit risk as its owner without a guarantee or another formal support arrangement. Nevertheless, state or local government ownership can help bolster a housing provider's credit profile thorough implicit support. This support can take the form of facilitated access to external sources of capital or, in extreme cases, direct financial support. When assessing this support, the relationship between the housing provider and the government body is examined, as well as the strategic importance of the housing provider to the government body. Those providers that have key social roles or that dominate the local provision of social and rented housing inevitably have greater strategic importance than other providers. The monitoring and level of control the owner exerts on the housing provider is also examined as well as any actions it might take such as requiring one-off dividends from the housing provider or forcing it to sell assets to create a more open housing market as has happened with some Swedish local housing companies. Housing policy and support. Given their not-for-profit status and sometimes niche market positions, social and public housing providers will always be very sensitive to government policy. The social housing sector's size and importance within the housing market will influence its role in government policy and the allocation of government resources, as will local or national demand for social housing. Finally, the political nature of this support will be analyzed to assess whether the housing providers and broad housing policy enjoy cross-party political support or whether they could be subject to considerable change. The level of direct and indirect financial support available to housing providers varies considerably from government to government, although most are stepping back from providing direct financial support to public and social housing providers. The U.K. government was one of the first to do so, removing revenue deficit grants in 1989 and significantly reducing major repair grants. In The Netherlands, the government has largely stepped back from providing direct financial support to housing associations. Consequently, most Dutch housing association funding requirements are now met through the capital market and the government is actively encouraging the growth of home ownership at the expense of the social housing sector. Although the role of the Dutch government has diminished and there is no suggestion that it would step in to save any individual housing associations, it still provides a relatively supportive framework for individual housing associations, with institutions such as the government created Central Fund providing financial support for troubled housing associations. The U.K. government still provides capital grants to help finance the development of new assets and, in both countries, public and social housing providers benefit significantly from indirect financial support from the government. This is because the governments provide a means-tested rental subsidy, which helps underpin the housing provider's rental income. Regulatory behavior. In some public housing markets, the governmental owner acts as "quasi-regulator" while an independent regulator such as the Housing Corporation in England exists in other markets. Either way, Standard & Poor's analyzes the transparency, adequacy, and certainty of regulatory policies and the length of time the regulatory framework has been in place. Regulatory treatment should be timely and should allow consistent, predictable performance given the importance of financial stability as a rating factor. The regulator's legal powers and its ability to intervene to force change will also be assessed as will the quality of its monitoring of an individual housing provider's operating and financial performance. Finally, while one cannot assume that what happened in the past will always happen in the future, the regulator's history of direct intervention and financial support in emergencies will nevertheless help signal both the effectiveness of its powers and its policy stance. Another key consideration is whether the owner or regulator imposes any restrictions on housing providers' revenue-raising powers or any control over its commercial objectives. In those governments where the flexibility to raise rents is significantly constrained, the individual housing providers are likely to come under more financial pressure and have less scope to react to adverse events by raising revenues. There is often tension between different aspects of government or regulatory policy (for example promoting a viable public housing sector and trying to keep rents low). Such tension can impact on an individual provider's credit quality. In many countries where government policy caused a wholesale problem across the housing sector, one might expect the government to amend this policy or provide other avenues of support at a sector level, especially if the sector was an essential mechanism through which the government met its policy objectives. This is not the same, however, as assuming that the government would step in to provide direct support for any individual provider that could be in financial trouble, especially if there are other reasons such as high debt, poor management, or lack of demand. In other countries such as New Zealand and France, the government's regulatory framework is even tighter although the housing sector in these countries should still not be confused with government risk. For example in France, the social housing sector has traditionally been highly regulated by the central government through regulated rents, favorable tax regulation, subsidized long-term lending, and a guarantee fund in case of financial difficulty. Some concerns and pressures have risen, however, as the cost of rent and loan subsidization increases for the government and as social housing companies face pressures from rising maintenance costs, vacancies, and arrears in deprived arrears. Some companies are looking to refinance existing loans and non-traditional financing tools to generate some flexibility. The regulatory framework remains robust, however, and the political importance of the sector ensures continued government support to a sector, which remains globally sound even though there are large disparities owing to the economic environment, quality of infrastructure, and management capabilities. Operational Performance Void and arrears levels, tenant turnover, and average unit turnaround times are good indicators of operational performance and often vary considerably between different public housing providers, even those within the same locality or country. Other aspects of operational performance reviewed by Standard & Poor's include the housing provider's ability to control its repairs expenditure and its flexibility to reduce staff levels or major repairs expenditure without negatively affecting demand. Standard & Poor's also favors housing providers that focus on customer service and tenants' opinions. Operational systems, mechanisms to involve tenants in management decision-making and the results of any tenant satisfaction surveys and other performance indicators are therefore reviewed to help gauge the provider's success at meeting the needs of its core customers. Management is assessed for its role in determining operational success, its risk tolerance, and its strategic focus and leadership. The experience and tenure of senior management is considered, as is its ability to foresee and plan for potential challenges. Standard & Poor's evaluation of management is also sensitive to potential organizational problems such as: Significant organizational reliance on an individual; The finance function and finance considerations not receiving high organizational recognition; An unclear relationship between organizational structure and management strategy; and Conflict with the Board, regulator, or owners. Financial Performance When assessing the ongoing financial strength of a public or social housing provider Standard & Poor's focuses on its financial policies, its historic and projected operating performance, its capital structure and cash flow protection, and its financial flexibility. Financial policy. Standard & Poor's assesses the broad financial picture in the context of the financial goals, strategy, and polices of a housing provider. Some housing providers display a greater degree of risk-aversion in their financial and debt policies and other differences exist in their approach and quality of financial reporting, cash flow management, and budgetary control. Operating performance. Standard & Poor's analyzes a provider's financial statements for the most recent five-year period as well as for the forecast period. Given their not-for-profit nature, stable revenue streams and often strong levels of direct and indirect governmental support, Standard & Poor's does not expect to see the high levels of net operating surpluses generated by many other types of rated entity. Nevertheless, modest net operating surpluses-to-turnover results are important indicators of the provider's ability to meet its operating obligations, withstand unexpected shocks, attract external capital, and invest in its properties. Operating surpluses are subject to varying accounting conventions. This is particularly true for housing providers as they are very capital intensive. Consequently, the treatment of depreciation expenses greatly influences reported surpluses. Provided that Standard & Poor's is comfortable that the housing provider is adequately maintaining its housing base, this noncash item is normally adjusted to an EBITDA figure, when the ability of the provider to generate surpluses to cover its interest obligations is assessed. Standard & Poor's also reviews the housing provider's cost base and its ability to reduce costs if revenues decline. Capital structure. In measuring debt, Standard & Poor's takes into account long-term capital lease obligations and other off-balance-sheet financing as well as the debt portfolio's maturity and rate structure. Standard & Poor's believes that the true value of most social and public housing properties is best reflected by their ability to generate future rental streams rather than any asset sale on the open market. Therefore key financial ratios for analyzing a provider's debt burden is total outstanding debt relative to operating income and the ability of FFO to cover outstanding debt. Net debt per housing unit and gearing ratios are still useful, however, especially when considering the entity's flexibility in the bank market. The debt levels for many housing providers are increasing as new housing developments are being funded by a diminishing level of public funds. Standard & Poor's therefore pays particular attention to future debt requirements and the level of nondebt financing of new assets. Cash flow protection. Cash flow analysis is critical to all credit rating decisions. Interest or principal obligations cannot be serviced out of earnings, which is merely an accounting concept; payment must be in cash. To assess the level of debt servicing ability provided by internal cash generation, Standard & Poor's focuses primarily on the level of FFO and its relation to debt-service coverage and debt burden. Financial flexibility. The availability of cash or committed facilities to meet debt-service obligations in times of stress is an important aspect of financial flexibility, especially if the housing provider has a significant proportion of short-term or variable rate debt. Access to capital markets and the ability to sell assets are also important financial considerations. Other aspects include restrictive covenants on loan agreements that place the firm at the mercy of its bankers, or a limited supply of unencumbered assets that reduce the housing provider's ability to raise additional long-term finance. Table 1 The Key Areas of Financial Analysis and a Sample of Financial Ratios Used STANDARD & POOR'S FINANCIAL RISK FACTOR EXPLANATION/AREA COVERED A SAMPLE OF KEY STANDARD & POOR'S RATIOS Financial policy The management's philosophies and policies involving financial risk A review of key financial parameters that managements use to run their business, as well as their approach to debt, treasury management, budgetary control, and new areas Operating performance The ability to generate sufficient operating margins to be able to meet operating obligations, attract capital externally, and withstand business adversity - EBITDA coverage of gross interest expense (including capitalized interest) - operating surplus as a % of turnover - net surplus as a % of turnover - rent arrears and rent losses - total maintenance costs as % of turnover - net surplus per housing unit owned Capital structure The level of debt used by the entity and quality of asset base - income as % of debt - growth in income/growth in debt - gearing - (capital grants + asset sale receipts + FFO)/gross acquisition and construction costs - debt per unit Cash flow protection The level of debt servicing ability provided by the internal generation of cash - cash flow coverage - FFO interest coverage - FFO as a % of average total debt Financial flexibility The range of options available to the entity when under stress - cash + net working capital/annual debt service - level of unencumbered assets - short-term debt as % of total debt - interest payable as % of operating revenues