S&P Global Ratings

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## Research Update:

# Hyde Housing Association Downgraded To 'A' On Sales Risk; Outlook Stable

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## Overview

- We expect U.K.-based Hyde Housing Association to maintain its market-related activities program such that sales revenues exceed 35% of total revenues over the next two to three years.
- While we note Hyde's commitment to de-risk its business and maintain solid financial performance by improving margins in its core social housing business, our view is that its dependence on revenues from market sales activities amplifies the potential volatility of Hyde's operating margins.
- We are therefore lowering our long-term rating on Hyde to 'A' from 'A+'.
- The stable outlook reflects our expectation that Hyde's management will continue to efficiently manage its social housing business and cover interest costs from low risk earnings sources, offsetting the relatively high exposure to real estate market risks.

## Rating Action

On July 24, 2018, S&P Global Ratings lowered its long-term issuer credit rating on U.K. social housing provider Hyde Housing Association to 'A' from 'A+'. The outlook is stable.

We also lowered to 'A' from 'A+' our long-term issue rating on Hyde's £250 million senior secured debt and on the £400 million bond issued by Hyde's core subsidiary Martlet Homes Ltd.

## Rationale

The downgrade reflects our expectation that Hyde will maintain its development-for-sales program over the next three years, which in our base-case scenario comprises more than a third of total revenues. We believe that the group's exposure to a more volatile business could stretch its financial position and reduce the headroom to withstand external risks. We recognize that this is a structural trend in the industry to mitigate a reduction in government grant funding. Nevertheless, in our view, it elevates risk levels for Hyde by exposing the business to cyclical and potentially more volatile revenue sources. We note, however, that Hyde has improved its balance sheet through a debt restructuring completed in 2017 and now reflected in a very strong liquidity position. We also expect limited debt increase over our forecast period, in line with Hyde's commitment to de-risk its business and maintain solid financial performance by improving margins on its core social housing business.

Moreover, Hyde's creditworthiness benefits in our view from 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. Therefore, the final rating on Hyde is one notch above its stand-alone credit profile. Our view of a moderately high likelihood of extraordinary government support is based on our assessment of Hyde'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 believe that the industry risk for English social housing entities with a high and mounting reliance on sales activities, particularly outright sales and first-tranche shared ownership sales, has structurally increased. With the reduction in grant funding and detrimental effect from welfare reforms, housing associations have in recent years gradually expanded into market-related activities to cross-subsidize affordable and social housing development. Although we consider that Hyde's development plan is more gradual than some of its peers, these activities nonetheless expose it to higher risks. Unlike traditional rental activities, we consider that sales 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 given the significantly higher level of competition.

In our view, consumer confidence, disposable income, employment levels, and growth, as well as interest rates and the availability of mortgage loans, would ultimately drive demand for the properties for sale, which heighten revenue and earnings volatility. Additionally, high variability in sales levels and property valuations, as manifested by recent fluctuations in U.K. housing prices, render social housing groups vulnerable to business cycle blips.

Hyde's enterprise profile continues to be underpinned by strong economic fundamentals due to the focus of its operations on the dynamic London and neighboring South East area. It benefits from stronger population growth than the national average along with higher market rent than that of Hyde's social and affordable housing properties, which supports a robust demand for social housing.

We view management as non-risk averse, albeit demonstrating good expertise in managing costs and gradually improving the entity's performance and liquidity position. Hyde is effectively planning to develop an average of about 1,100 homes per year over the next three years from its own financial resources and 400 more per year from other capital, mostly joint ventures.

In our view, the group's market-related activities will continue to constrain its financial profile. We project that revenues from outright and first tranche-shared ownership sales will be close to 40% of total revenues over the next two years before declining in 2021. This compares with less than 20% of revenues coming from sales in FY2018. Due to the increasing importance of the private sales activity and a continuing negative impact of sector's rents cuts until 2020, we expect Hyde's financial performance to weaken. We forecast Hyde's adjusted EBITDA margin will average 29% over FY2019-2021, marginally down from 31% in FY2018 before it starts increasing again from 2021 thanks to the new rent settlement and lower revenues from sales.

We view it positively that the group has limited exposure to interest rate fluctuations, has a smooth debt maturity profile, and also improved its covenants after the completion of its refinancing. Furthermore, we positively note that debt/adjusted EBITDA will decrease over our base case to less than 14x in FY2021 from 17x in FY2018, as Hyde is planning to limit debt accumulation. Also, while Hyde's EBITDA and social housing lettings interest cover ratios are weaker than those of rated peers, they will cover interest costs with some headroom through 2021.

### Liquidity

We consider Hyde's liquidity position to be very strong thanks to its high levels of cash; large undrawn credit facilities, especially after refinancing completed in 2017; and satisfactory access to capital markets. In our base case, we estimate sources of cash will cover uses by more than 2.5x over the next 12 months.

Liquidity sources include:

- Cash of £80 million;
- Cash flow from operations totaling £120 million;
- Available funds under undrawn committed facilities expiring beyond 12 months of £435 million; and
- Grants and other income of about £60 million.

Liquidity uses include:

- Capital expenditure of close to £135 million;
- Debt service (including interest costs) of £120 million; and
- Breakage costs and other costs of more than £35 million.

## Outlook

The stable outlook reflects our view that while Hyde 's development program could result in pressure on financial performance amid more volatile cash flow generation, such risks are mitigated by continued strong housing demand and Hyde's ability to cover interest payments from a low risk income source.

We could lower the ratings if Hyde's financial performance and debt profile deteriorated, compared to our current base-case expectation. This could occur if debt rises faster than earnings from social housing lettings, or if sales increase materially beyond 30%-40% of total revenues over our forecast horizon. We could also lower the rating if we think that the likelihood of support from the government has weakened.

We could raise the ratings if Hyde materially reduced its exposure to market-related activities, and at the same time, we observed its financial performance improving structurally with Hyde's ability to control indebtedness to current levels and cover interest payments from low-risk income sources materially increasing.

## Selected Financial Indicators

**Table 1**

**Hyde Housing Association Selected Financial Indicators**

| | --Year ended March 31-- | | | | |
|---|---|---|---|---|---|
| **(Mil. £)** | **2017a** | **2018e** | **2019bc** | **2020bc** | **2021bc** |
| Number of unites owned or managed | 46,516 | 49,173 | 49,685 | 49,108 | 49,309 |
| Vacancy rates (% of rent net of identifiable service charge) | 0.8 | 0.4 | N.A. | N.A. | N.A. |
| Arrears (% of rent net of identifiable service charge)* | 4.2 | 3.7 | N.A. | N.A. | N.A. |
| Revenue§ | 304.9 | 328.7 | 437.8 | 434.7 | 380.0 |
| Share of revenue from nontraditional activities (%) | 26.2 | 31.2 | 47.5 | 48.0 | 39.0 |
| EBITDA† | 90.5 | 102.0 | 119.2 | 121.5 | 123.2 |
| EBITDA/revenue (%) | 29.7 | 31.0 | 27.2 | 28.0 | 32.4 |
| Interest expense | 80.3 | 86.8 | 87.9 | 88.4 | 87.7 |
| Debt/EBITDA (x) | 15.5 | 16.5 | 14.2 | 13.9 | 13.5 |
| EBITDA/interest coverage** (x) | 1.1 | 1.2 | 1.4 | 1.4 | 1.4 |
| Capital expense | 157.4 | 163.2 | 148.9 | 101.5 | 87.9 |
| Debt | 1,402.8 | 1,684.0 | 1,694.1 | 1,683.0 | 1,658.1 |
| Housing properties (according to balance sheet valuation) | 2,915.0 | 2,973.1 | 3,031.1 | 3,078.0 | 3,113.0 |
| Loan to value of properties (%) | 48.1 | 56.6 | 55.9 | 54.7 | 53.3 |
| Cash and liquid assets | 44.5 | 80.5 | 80.5 | 80.5 | 86.6 |

*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.

## Rating Score Snapshot

**Table 2**

| **Hyde Housing Association** | |
|---|---|
| Industry Risk | 3 |
| Economic fundamentals and market dependencies | 2 |
| Strategy and management | 3 |
| Asset quality and operational performance | 1 |

**Table 2**

| Hyde Housing Association (cont.) | |
|---|---|
| Enterprise profile | 3 |
| Financial performance | 5 |
| Debt profile | 3 |
| Liquidity | 2 |
| 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
- 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

- U.K. Housing Association Guinness Partnership Rating Lowered To 'A' On Higher Sales And Volatility Risk; Outlook Stable, July 24, 2018
- U.K.-Based Metropolitan Housing Trust Ratings Lowered To 'A-' On Higher Sales Risk; Outlook Now Stable, July 24, 2018
- U.K.-Based Social Housing Association GreenSquare Group Ltd. Rating Lowered To 'A-' On Higher Sales Risk; Outlook Stable, June 20, 2018
- Places for People Group Rating Lowered To 'A-' On Increased Exposure To Market Sales; Outlook Now Stable, June 20, 2018
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018
- U.K. Social Housing Providers To Borrow £12 Billion Of New Debt By 2020 Total Debt to Reach £89 Billion, March 7, 2018

- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 27, 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 |
|---|---|---|
| Hyde Housing Association Ltd | | |
| Issuer Credit Rating | A/Stable/-- | A+/Negative/-- |
| Hyde Housing Association Ltd | | |
| Senior Secured | A | A+ |
| Martlet Homes Ltd. | | |
| 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.