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**Research Update:**

## U.K. Housing Association Guinness Partnership Rating Lowered To 'A' On Higher Sales And Volatility Risk; Outlook Stable

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## Overview

- Despite the majority of revenues coming from traditional activities in the current year, we project a significant step-up in sales, which will account for nearly 40% of revenue from full-year 2020.
- In our view, this increases risk for Guinness, albeit from a very strong position. Moreover, we believe this strategy will dampen operating performance and elevate volatility in the business.
- We are therefore lowering our long-term rating on Guinness to 'A' from 'A+'.
- The stable outlook reflects Guinness' strong financial position, with low debt levels and strong operational performance. We believe it will continue to manage its social housing business effectively, and that this will help cover its interest payments comfortably.

## Rating Action

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

We also lowered the long-term rating to 'A' on Guinness' senior secured debt of £250 million due 2044 and £100 million due 2037.

## Rationale

The downgrade reflects our expectation that Guinness will significantly increase the scale of its development plans, to provide cross subsidy for the construction of homes for social rent, thus increasing its focus on market-related activities in the coming years. From full-year (FY) 2020, Guinness will develop approximately 1,500 units a year, up from 400 in FY2019. Therefore, we envisage that sales, as a proportion of total revenues, will stabilize at around 40% by FY2020. However, due to a cyclical trough in development and delays in one large scheme, this proportion dropped to just 5% in FY2019.

Guinness also faces sectorwide challenges from a reduction in government grant

funding and ongoing welfare reforms in the country. Therefore, we believe the shift towards more market-based activities, particularly outright sales and first tranche shared ownership sales, is an effort to offset grant attrition and generate internal subsidy for sub-market development.

However, unlike social rental income, these expose housing associations to higher cyclical risk in the residential property development sector. Growth in this sector is less predictable than in social housing given the significantly higher level of competition. Consequently, we think it elevates industry risk for Guinness compared to a traditional social housing association.

That said, Guinness' core purpose as a registered provider remains the provision of more affordable homes in the U.K. Furthermore, it benefits from regulatory oversight from the Regulator of Social Housing. In the event Guinness were to face financial distress, we believe there is a moderately high likelihood that the U.K. government will provide extraordinary support in a timely manner. Therefore, our rating is one notch above the stand-alone credit profile.

Guinness' strong enterprise profile is underpinned by the robust condition of its well managed asset base, in our view. Consistently low vacancy rates of less than 1% support its strong operational performance. All of its roughly 67,000 properties meet the U.K. government's decent home standard assessment, unless there is a waiver in place, are spread nationally, and have an average age of 30 years.

Overall economic fundamentals are slightly weaker when compared to other London-based peers. This is because a large portion of Guinness' stock is located outside London. Its expanded geographic reach promotes greater revenue diversity and risk reduction, but also means that it operates in less-dynamic areas where population growth lags national levels.

In line with Guinness' strategy to divest from the Midlands and the North East and focus on high growing areas in London, the South East and Manchester, we anticipate strengthening fundamentals in the coming years.

Risks emanating from market sales will likely weigh on Guinness' financial performance going forward. We anticipate this will heighten volatility in the coming years. Furthermore, over our forecast period, we estimate EBITDA margins will trend down toward 30% given the exposure to low-margin market sales, but also as a result of rent cuts up to FY2020 and higher inflation. That said, core business margin in social housing is sound, and consistently above 35% (despite higher cost of maintenance and rent cuts). On the other hand, sales generate significantly lower margins of about 20%-25%, dragging overall group margins down.

Guinness has moderately low debt burden, when compared to sector peers. We estimate debt to remain slightly below 10x S&P adjusted EBITDA in our forecast years. Our projection is predicated on 50% increase in EBITDA between FY2019

and FY2020 as Guinness begins to realize sales receipts. More than 80% of £1.2 billion of total drawn debt as of FY2018 is fixed.

We do not expect an increase in borrowings in FY2019 as developments will be covered by internal liquidity. Beyond that, we expect borrowing to increase by £200 million in FY2020 and FY2021. Social housing lettings interest coverage will remain strong, at an average of 1.6x over our base-case. Furthermore, approximately 18,000 units are currently unencumbered. This can support additional borrowing capacity of £800 million, which, at more than 60% of total drawn debt will cushion downside risk.

Overall we see financial policies as a rating strength, as we continue to observe high liquidity and prudent debt management. We consider positively the fact that all committed pipeline is covered with cash in hand and secured liquidity lines and in this way avoid reliance on sales receipts.

In accordance with our criteria for government-related entities, we base our view of the likelihood of extraordinary government support on our assessment of Guinness' important role for the U.K. government and its public policy mandate, and its strong link with the U.K. government. The U.K. government has a track record of providing extraordinary support to the sector in case of distress.

### **Liquidity**

We consider that Guinness has a very strong liquidity position owing to its high levels of undrawn liquidity facilities and fixed asset sale receipts of £90 million. In our base case, we estimate sources of cash will cover uses by around 2.3x.

Liquidity sources include:

- Forecasted cash generated from continuing operation: £125.4 million
- Cash and liquid investments: £25 million
- Proceeds from asset sales: £90.4 million
- Undrawn, available portion of committed facilities maturing beyond the next 12 months: £362 million (we exclude facilities where security is not currently charged).

Liquidity uses include:

- Adjusted expected capital expenditure: £168.8 million
- Interest and principal payable on short- and long-term debt obligations coming due: £92.7 million

### **Outlook**

The stable outlook reflects our view that despite the increased exposure to market-related activities, Guinness will maintain its low debt level, and comfortably cover interest payments from low risk income sources.

We could lower the rating if exposure to market sales deviates from the current plan such that pressure on Guinness' liquidity position increases. Separately, downward pressure on the rating will increase if debt persistently rises faster than operating earnings.

We could also lower the rating if we believe the likelihood of timely extraordinary support from the U.K. government to Guinness were to decrease in our view.

Alternatively, we could raise the rating if we observe a structural move to reduce market sales and at the same time, there is no deterioration in the financial risk profile.

## Key Statistics

The Guinness Partnership Selected Financial Indicators					
	--Year ended March 31--				
(Mil. £)	2017a	2018e	2019bc	2020bc	2021bc
Number of unites owned or managed	66,684	66,779	67,202	68,687	70,262
Vacancy rates (% of rent net of identifiable service charge)	0.7	N.A.	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	3.9	N.A.	N.A.	N.A.	N.A.
Revenue§	415.8	359.2	353.3	564.4	589.2
Share of revenue from nontraditional activities (%)	26.8	10.1	8.6	41.6	41.6
EBITDA†	146.5	122.3	111.3	167.8	174.6
EBITDA/revenue (%)	35.2	34.0	31.5	29.7	29.6
Interest expense	60.4	63.0	70.7	84.7	98.6
Debt/EBITDA (x)	8.7	10.2	11.1	8.4	9.1
EBITDA/interest coverage** (x)	2.4	1.9	1.6	2.0	1.8
Capital expense	52.4	60.5	96.3	386.3	391.0
Debt	1,270.3	1,252.8	1,237.2	1,417.6	1,597.4
Housing properties (according to balance sheet valuation)	3,085.3	3,101.5	3,105.3	3,491.1	3,894.9
Loan to value of properties (%)	41.2	40.4	39.8	40.6	41.0
Cash and liquid assets	73.9	78.7	74.0	89.0	107.2

\*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.

## Ratings Score Snapshot

The Guinness Partnership Ratings Score Snapshot	
Industry Risk	3
Economic fundamentals and market dependencies	4
Strategy and management	3

### The Guinness Partnership Ratings Score Snapshot (cont.)

Asset quality and operational performance	1
Enterprise profile	3
Financial performance	5
Debt profile	2
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: Guarantee Criteria, Oct. 21, 2016
- 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: 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.-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
- New Rent Policy Brings Relief, But No Big Boost To The Credit Standing Of U.K. Housing Associations, Jan. 31, 2018
- U.K. 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; CreditWatch/Outlook Action

	To	From
Guinness Partnership (The) Issuer Credit Rating	A/Stable/--	A+/Negative/--

### Downgraded

	To	From
Guinness Partnership (The) 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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