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Research Update:

Genesis Housing Association 'A-' Rating Maintained On CreditWatch Positive On Potential Merger With Notting Hill

Primary Credit Analyst:
Karin Erlander, London (44) 20-7176-3584; karin.erlander@spglobal.com

Secondary Credit Analyst:
Jean-Baptiste Legrand, London (44) 20-7176-3609; jb.legrand@spglobal.com

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Overview

- We think that Genesis Housing Association's enterprise profile has strengthened, mainly due to lower arrears. Its finanical risk profile has developed more negatively than we expected, however, due to lower earnings and weaker profitability than we forecast.
- We forecast a gradual improvement in adjusted EBITDA margins over the next two years, which we think will result in stronger debt service coverage ratios.
- We are maintaining the 'A-' issuer credit rating on Genesis on CreditWatch Positive, where we placed it on July 21, 2017, after Genesis announced that it has agreed to merge with Notting Hill Housing Trust.
- The CreditWatch placement continues to reflect our view that it is highly likely that the merger will take place and that we could raise the rating on Genesis by up to two notches. Because we continue to project that the combined entity would demonstrate stronger profitability and lower leverage than Genesis on a stand-alone basis, we anticipate a pronounced strengthening of Genesis' creditworthiness if the merger is completed.

Rating Action

On Oct. 23, 2017, S&P Global Ratings kept on CreditWatch positive its 'A-' long-term issuer credit rating on U.K.-based social housing provider Genesis Housing Association.

Rationale

The rating action reflects our view that it remains highly likely that Genesis will complete its merger with Notting Hill Housing Trust, leading to a pronounced strengthening of Genesis' creditworthiness. The rating continues to incorporate our view that Genesis benefits from strong economic fundamentals exhibited in its areas of operation, predominantly the Greater London area. We also take into account Genesis' high asset quality, and its lower arrears than we had previously assumed has led us to reassess its enterprise profile as very strong. However, we continue to observe relatively weak financial performance compared with its London-based peers, with S&P Global Ratings-adjusted EBITDA margins consistently below 20%. In combination with an expected increase in debt over the next two years, this results in a weaker assessment of its financial profile.

The strengthening of Genesis' business risk profile mitigates a weakening of its financial risk profile. We also forecast a gradual strengthening of its earnings and profitability, which should result in strengthening debt service coverage ratios. We therefore continue to assess Genesis' stand-alone credit profile (SACP) as 'bbb'.

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We continue to assess the likelihood of extraordinary support from the U.K. government, working through the Homes and Communities Agency (HCA), in case of financial distress, as moderately high, providing a two-notch uplift to the SACP. We base our view of the likelihood of extraordinary government support for Genesis on our assessment of its important role for the U.K. government and its public-policy mandate, and its strong link with the government, via the HCA.

Genesis' SACP is supported by a very strong enterprise profile within the social housing sector, which we continue to view as a low-risk industry. With around 30,000 units across Greater London and the East of England, Genesis continues to benefit from areas that demonstrate a strong demand for social housing, shared ownership, and outright sales. Genesis' arrears are lower than previously assumed, accounting for 4.2% of revenues in the financial year (FY) to March 2017, compared to our previous assumption of over 6%, and the group continues to benefit from low vacancy rates of about 2%.

Genesis' financial risk profile has weakened and we now assess it as vulnerable, with adjusted EBITDA margins of just 15% in FY2016 and 18% in FY2017. However, we expect management's strategy--reducing its temporary housing business while increasing its proportion of outright sale of housing units on the open market and sale of first-tranche shared ownership units--to result in a gradual improvement of EBITDA margins to closer to 20% over the next two years. Genesis' revenues from social lettings has been squeezed due to the 1% annual rent cut that is in place until March 31, 2020, along with an increase in inflation that has driven up costs and subsequently depressed margins. We also consider that negative margins generated within the temporary housing segment is driving down overall EBITDA margins.

Genesis' development program is predominately focused on the Greater London area, which includes a pipeline of more than 1,100 homes planned for completion by 2019. Of these, we expect 60% will be developed for affordable rent with the remaining 40% being allocated to outright sales and market rent. While we continue to factor in the risk associated with being exposed to nontraditional activities, outright sales in particular, into both the enterprise and financial risk profile, we think that in the near-to-medium term these activities will support an improvement in the group's profitability. We understand that Genesis' revenues from the lower-margin temporary housing busness will gradually decline over time, as evidenced by the reduction in units in this segment between FY2016 and FY2017, offering additional support to the group's EBITDA margins.

Although Genesis' current development plan is fully funded, we anticipate a gradual increase in debt over the next two years to around £1.9 billion by March 2019 from £1.5 billion in FY2017. We forecast under our base case that Genesis' adjusted debt-to-EBITDA ratio will fall to about 20x by March 2018, from 33x in FY2017, supported by a forecast improvement in EBITDA, and continue to improve in FY2019, to less than 17x. Historically, Genesis had a weak adjusted EBITDA/interest coverage ratio of less than 1x (0.7x in FY2016 and 2017), however we forecast that Genesis will improve their interest coverage with EBITDA covering their interest on average by 1.0x in FY2018 and 1.3x in FY2019.

Liquidity

We continue to assess Genesis as having a strong liquidity position. We forecast sources to exceed uses over the next 12 months by 1.5x. This is supported by cash holdings of about £55 million, access to close to £230 million of undrawn committed facilities, forecast asset sales proceeds of more than £130 million, and cash flow from operations of close to £20 million. Genesis' main use of liquidity is capital expenditures of close to £180 million, along with interest and amortization of debt totaling close to £115 million. We assess Genesis' access to external liquidity as satisfactory.

CreditWatch

We placed Genesis' ratings on CreditWatch with positive implications on July 21, 2017, following the announcement on July 20 that Genesis had entered into an agreement to merge with Notting Hill Housing Trust. We think that the stronger credit quality of Notting Hill and the synergies that would stem from an enlarged housing association would bolster Genesis' creditworthiness, which, following the merger, would represent the credit health of the combined entity. In particular, we estimate that the combined entity would demonstrate stronger profitability and lower leverage than Genesis currently. These positive factors, together with our expectation of increased flexibility from operating as a significantly larger entity, comprising over 60,000 homes across Greater London, would lead us to consider an upgrade of Genesis.

While we understand that the merger process has been somewhat delayed, we continue to view as highly likely that Genesis and Notting Hill will merge and that the combined entity would have a stronger credit profile than Genesis on a stand-alone basis. Based on our assessment of each company's enterprise and financial risk profiles, we think that we could raise the rating on Genesis by up to two notches if the merger is completed. We will resolve the CreditWatch placement within the next 90 days because we think that during this period we will have gained further clarity around the completion of the merger.

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: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Research Update: Notting Hill Housing Trust Affirmed at 'A+'; Outlook Remains Negative - September 15, 2017
- Genesis Housing Association 'A-' Rating On CreditWatch Positive On Potential Merger With Notting Hill Housing Trust – July 21, 2017

- Research Update: U.K.-Based Genesis Housing Assn. Assigned 'A-' Rating; Outlook Negative - March 09, 2017

Ratings List

	Rating	
	To	From
Genesis Housing Association		
Issuer Credit Rating		
Foreign and Local Currency	A-/Watch Pos/--	A-/Watch Pos/--

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.

Additional Contacts:
Christopher Mathews, London (0) 207 176 7115; christopher.mathews@spglobal.com
International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com