

Research Update:

# Scotland-Based Wheatley Housing Group Outlook Revised To Stable On Improved Liquidity; 'A+' Rating Affirmed

May 22, 2019

## Overview

- European Investment Bank funding and a private placement secured over the past 12 months have strengthened Wheatley Housing Group's (Wheatley) liquidity position, which will support the development and completion of new units.
- We expect the development of affordable homes, combined with planned cost savings, will result in improved underlying financial performance.
- We are revising the outlook to stable from negative and affirming the 'A+' long-term issuer credit rating on Wheatley.
- The stable outlook reflects our view that Wheatley will continue to focus on strengthening financial performance, while at the same time retaining its strong liquidity position.

## Rating Action

On May 22, 2019, S&P Global Ratings revised to stable from negative its outlook on Scottish registered social landlord (RSL) Wheatley Housing Group (Wheatley). At the same time, we affirmed the 'A+' long-term issuer credit ratings on Wheatley and core group entity The Glasgow Housing Association Ltd.

We also affirmed our 'A+' issue rating on the £300 million bond issued by Wheatley Group Capital PLC, the group's wholly owned subsidiary.

## Rationale

The outlook revision reflects Wheatley's improved financial profile, which is supported by its stronger liquidity position so far in the financial year ending March 31, 2019 (FY2019). This has led us to revise upward the stand-alone credit profile to 'a+'. Wheatley has secured funding from the European Investment Bank (EIB) and a private placement over the past 12 months. Combined with

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the existing undrawn facilities Wheatley already had, this funding now amounts to about £410 million. We view positively the group's decision to secure funding as it continues to deliver its development target of about 2,200 unit completions by the end of FY2022. The stable outlook also reflects our expectation that Wheatley will continue to improve financial performance, driven by cost savings and the ability to increase rents on its expanding asset base. We have restated our adjusted EBITDA, which now includes a higher amount of capitalized repairs. We now include the capitalization of replacement of components, leading to lower adjusted EBITDA margins. However, this does not materially affect the metrics in our debt profile. We are therefore affirming the 'A+' issuer credit rating.

Wheatley's asset base stretches across the central belt of Scotland, covering 17 local authorities from West Dunbartonshire in the west to East Lothian in the east, including Glasgow and Edinburgh in between. Wheatley's rents are low compared to the market average, which supports demand for the group's stock. Specifically, its social rents are about 50% of market rents, which is particularly low considering market rents tend to be lower in the U.K.'s devolved regions, such as Scotland. However, population growth--which is another factor we use to assess demand--remains fairly low at 0.5%.

Demand for Wheatley's stock is also reflected in its low vacancy rates, which averaged 0.7% between FY2017 and FY2019. This is lower than the 1%-2% that we tend to observe across our rated portfolio. We think Wheatley's low vacancy rates reflect the high quality of their assets. The group's large asset base comprises about 52,000 units as of FY2019, and we forecast it to grow. The group plans to invest about £1.2 billion over the next five years in both new and existing properties. We therefore expect Wheatley to retain exceptional asset quality, which remains a rating strength. That said, gross arrears are relatively high, albeit declining, at 6.2% of rent and service charge receivable. Wheatley has reduced arrears over the past three years, using its housing officer team and its Trusted Partner status with the Department of Work and Pensions to proactively identify vulnerable tenants.

Wheatley's strategy and management remains a rating strength. The group does not incorporate sales into its strategy, with all development planned to include only affordable and mid-market homes. Although not classified as social tenure in Scotland, mid-market homes are a form of subsidized housing and rents remain lower than market rents.

When calculating our adjusted EBITDA metrics, we deduct amortized grants and the cost of capitalized repairs from reported EBITDA. However, we now also deduct the cost for component replacements. This affects our assessment of financial performance, with Wheatley's five-year adjusted EBITDA margins dropping to an average of 27.5% over our base case, down from an average of 32.5% forecasted previously. Although these margins are lower, Wheatley can raise rents and implement cost-saving measures, which supports the group's underlying improvement in financial performance. We expect Wheatley to look at consolidation in its operating structure over our base case, which we expect will result in some cost savings.

Although we expect government grants to fund nearly 50% of Wheatley's development plan, the group will still require debt to fund the rest of the cost. We project debt to increase steadily to £1.37 billion in FY2022 from £1.22 billion in FY2019. Our revised EBITDA projections have caused a slight increase in Wheatley's debt-to-EBITDA and EBITDA interest coverage ratios. However, this does not materially change our view of Wheatley's debt profile. We forecast average debt to EBITDA of 15x and average EBITDA interest coverage of 1.3x. We also note that the increase in value in Wheatley's asset base has resulted in an improvement in its loan-to-value ratio. Wheatley revalues its stock periodically, with its high-rise towers contributing to the overall increase in asset base value.

We think Wheatley benefits from a high likelihood of timely and sufficient extraordinary support

from the Scottish government, through the Scottish Housing Regulator, in the event of financial distress. In accordance with our criteria for government-related entities, including Wheatley, we base our view of a high likelihood of extraordinary government support on our assessment of the group's very important role for the Scottish government and its public policy mandate, as well as its strong link with the Scottish government. This is demonstrated by the government's track record of providing strong credit support to the sector in certain circumstances. The regulator views Wheatley as a systemically important RSL because it thinks that financial distress for Wheatley could make it difficult for the regulator to fulfill its statutory objective of protecting tenants. Wheatley lies in the regulator's high category of engagement, based on its size of about 52,000 units, turnover, debt levels, and significance in its areas of operation.

## **Liquidity**

We note an improvement in Wheatley's liquidity position, bolstered by EIB funding and a private placement that the group has secured over the past 12 months. Wheatley secured £185 million of funding with the EIB in July 2018. We expect sources of funding to cover uses by 2.4x over the next 12 months.

Sources include:

- Adjusted EBITDA as a proxy for cash flow from operations of £81 million;
- Cash and liquid investments of £24 million;
- Undrawn facilities of £412 million; and
- Other receipts (government grants) of £41 million.

Uses include:

- Adjusted capital expenditure (net of capitalized repairs) of £147 million;
- Interest and principal repayments of £88 million; and
- Forecasted working capital outflows of £1 million.

We continue to view Wheatley's access to external liquidity as satisfactory.

## **Outlook**

The stable outlook reflects our view that Wheatley will continue to focus on strengthening financial performance while retaining its strong liquidity position.

## **Downside scenario**

We could lower the rating on Wheatley if we were to see a deterioration in the group's financial profile. This could materialize if Wheatley's financial performance does not improve in line with our base case, which could put pressure on cash flow from operations, in turn weakening the group's liquidity and leading to further debt.

We could also consider a downgrade if economic conditions were to weaken significantly in Scotland post-Brexit, limiting the government's ability to support the social housing sector.

## Upside scenario

We could raise the rating if we saw an overall improvement in the financial profile, supported by increased earnings and structural debt reduction. In such a scenario, we would see EBITDA margins trending above 30% and debt to EBITDA falling close to or below 10x.

Table 1

### Wheatley Housing Group Ltd. Key Statistics

(Mil. £)	--Year ended March 31--				
	2018a	2019e	2020bc	2021bc	2022bc
Number of units owned or managed	51,788	52,668	53,434	54,084	54,658
Vacancy rates (%)*	0.8	0.8	N.A.	N.A.	N.A.
Arrears (%)*	6.2	N.A.	N.A.	N.A.	N.A.
Revenue§	267.0	279.4	288.3	301.4	314.9
Share of revenue from nontraditional activities (%)	17.7	17.8	17.9	18.9	19.1
EBITDA§†	63.4	72.0	80.7	89.8	94.6
EBITDA/revenue §†(%)	23.7	25.8	28.0	29.8	30.0
Interest expense‡	59.6	61.0	62.5	63.5	67.0
Debt/EBITDA §†(x)	17.2	16.9	15.4	14.5	14.5
EBITDA/interest coverage§†‡ (x)	1.1	1.2	1.3	1.4	1.4
Capital expense‡	171.2	168.4	150.0	114.8	133.1
Debt	1,091.4	1,218.9	1,246.0	1,299.3	1,374.8
Housing properties (according to balance sheet valuation)	1,775.8	N.A.	N.A.	N.A.	N.A.
Loan to value of properties (%)	61.5	N.A.	N.A.	N.A.	N.A.
Cash and liquid assets	52.3	86.7	23.4	27.9	43.6

\*Rent and service charge. §Adjusted for grant amortization. †Adjusted for capitalized repairs. ‡Including capitalized interest. a--Actual. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. e--Estimate. N.A.--Not available.

Table 2

### Wheatley Housing Group Ltd. Ratings Score Snapshot

Industry Risk	2
Economic fundamentals and market dependencies	3
Strategy and management	2
Asset quality and operational performance	1
<b>Enterprise profile</b>	<b>2</b>
Financial performance	4
Debt profile	3
Liquidity	2
Financial policies	2

Table 2

## Wheatley Housing Group Ltd. Ratings Score Snapshot (cont.)

### Financial profile

3

S&P Global Ratings bases its ratings on non-profit social housing providers on the eight main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published on Dec. 17, 2014, summarizes how the eight factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating. For social housing providers generating more than a third of its consolidated revenues from open market sales, we also refer to the "Key Credit Factors For The Homebuilder And Real Estate Developer Industry."

## 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
- 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

- United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019
- Global Social Housing Ratings Score Snapshot: December 2018, Nov. 29, 2019
- Global Social Housing Risk Indicators: December 2018, Dec. 3, 2018

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Wheatley Housing Group Ltd.</b>		
<b>The Glasgow Housing Association Ltd.</b>		
Issuer Credit Rating	A+/Stable/--	A+/Negative/--
<b>Ratings Affirmed</b>		
<b>Wheatley Group Capital PLC</b>		
Senior Secured	A+	A+

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