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Research Update:

Housing New Zealand Ltd. Outlook Revised To Positive Following Similar Action On New Zealand; Ratings Affirmed

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Research Update:

Housing New Zealand Ltd. Outlook Revised To Positive Following Similar Action On New Zealand; Ratings Affirmed

Overview

- On Jan. 31, 2019, we revised the rating outlook on New Zealand to positive from stable.
- As a result, we are revising our outlook on the long-term ratings on Housing New Zealand Ltd. (HNZL) to positive from stable.
- HNZL is fully owned by Housing New Zealand Corp., which benefits from an almost-certain likelihood of extraordinary support from the New Zealand government. HNZL is a core part of the HNZN group. It accounts for about 97% of the group's assets and shares the same management and board.
- We are also affirming our 'AA+/A-1+' local-currency and 'AA/A-1+' foreign-currency ratings on HNZL.

Rating Action

On Jan. 31, 2019, S&P Global Ratings revised its outlook on Housing New Zealand Ltd. to positive from stable. At the same time, we affirmed our 'AA+/A-1+' local-currency and 'AA/A-1+' foreign-currency issuer credit ratings on HNZL.

Rationale

The outlook revision reflects a similar action on the New Zealand sovereign (see "New Zealand Outlook Revised To Positive On Improving Fiscal Position; 'AA+' LC And 'AA' FC Ratings Affirmed", published Jan. 31, 2019). HNZL is the main subsidiary of Housing New Zealand Corp. (HNZN), its 100% owner. HNZL makes up the bulk of the group's operations and manages most of its 64,000 properties on behalf of HNZN. HNZL is integral to HNZN's identity and strategies. Therefore, we consider HNZL to be core, as defined by our group rating methodology, to HNZN's operations. We consider our ratings on HNZL and HNZN to be intrinsically linked.

Our ratings on HNZN reflect its 'aa' stand-alone credit profile (SACP) and our view of an almost-certain likelihood of extraordinary support from its sole owner, the New Zealand government (the Crown), in a stress scenario.

HNZN is a statutory Crown entity responsible for providing high-quality state housing to people in need, alongside supporting the government's priorities in

the supply of emergency, transitional, KiwiBuild, and market housing. It is the largest residential landlord in New Zealand, owning about 61,500 properties and leasing a further 2,500, which collectively house about 185,000 people. Our analysis is based on HNZC and its three wholly owned subsidiaries: HNZL, HLC Ltd., and Housing New Zealand Build Ltd.

On Nov. 24, 2018, the Crown government announced the proposed formation of a new Housing and Urban Development Authority. The new authority will bring together HNZC, HLC Ltd., and a third Crown entity called KiwiBuild Unit. It will continue to act as a state housing landlord, with no change for HNZC's existing tenants. It will also lead the government's large-scale urban development projects, including its signature KiwiBuild program, which aims to deliver 100,000 new affordable homes over a decade. The government intends to introduce legislation to establish the authority into parliament in 2019. We understand that HNZL, the legal entity issuing medium-term notes to the market (discussed below), will either continue as a subsidiary of the authority or, if there is a reorganization, the new authority will assume all the obligations of HNZL in respect of the issued notes. This announcement has no immediate credit implications. However, we may reappraise the situation once we have further details about the proposed legislation.

In the interim, we expect HNZC's near-monopoly status in the provision of social housing to be further reinforced by reforms being enacted by the Crown government. One of the government's key priorities is to grow the supply of housing and public housing in New Zealand. The government has cancelled the Social Housing Reform Programme, which had aimed to encourage more diverse ownership of public housing, and cancelled the "stock transfer" program, which saw HNZC transfer several thousand properties to other community housing providers. Small-scale, business-as-usual property sales will continue to take place.

The government in August 2018 released its 2018-2022 Public Housing Plan. The plan outlines a strategy for securing around 6,400 net additional public housing properties across New Zealand by June 2022. HNZC will deliver about 70% of these new properties (i.e., around 1,100 net additional properties per year) and community housing providers will deliver the remaining 30%. The plan should see HNZC's total portfolio grow to over 68,000 properties by June 2022. While much of the growth will be in Auckland, the country's largest city, HNZC has also launched significant building programs in Wellington, Christchurch, and in multiple regional locations. HNZC added a net 720 properties to its stock in the 2017-2018 financial year.

Our assessment of HNZC's SACP reflects its very strong enterprise and financial profiles. Globally, we classify social housing as a low-risk industry. The industry tends to be stable, with relatively high barriers to entry and ongoing government subsidies in many jurisdictions. Economic fundamentals in New Zealand remain robust, and Stats NZ estimates that the population grew 1.9% in the year to June 2018. There is a high level of demand for HNZC's services, with the number of applicants on New Zealand's Social Housing Register increasing by 111% between June 2016 and June 2018.

In the near term, we believe that the HNZC group will continue to focus predominantly on the provision of low-income housing. Most tenants pay no more than 25% of their net income on rent. The Crown then pays to HNZC the difference between market rent and the tenant's income-related rent, in the form of an income-related rent subsidy. The HNZC group engages in a number of other activities, including offering home ownership financial products and HLC's role in the provision of land planning and development services. HNZC in May 2018 established its third subsidiary, Housing New Zealand Build Ltd., which we understand will construct and sell affordable properties to the public. However, these activities represent a fraction of the group's overall revenues and expenses.

We view HNZC's strategy and management as strong, and a key factor supporting the ratings. The organization has a track record of market leadership and innovation. To help deliver on its ambitious building targets, HNZC is making greater use of offsite manufacturing and new technologies such as cross-laminated timber. It will also implement multiyear contracts, providing greater certainty to suppliers, and roll out specific, repeatable designs for different housing types. HNZC has a large and mature asset base, with its housing portfolio having an average age of 45 years. Vacancy rates have averaged about 2.8% during the past three years.

The government in July 2018 appointed four new non-executive members to HNZC's board, including a new deputy chairperson, while reappointing the current chairperson until May 2019. Further, the government in September 2018 announced that it will seek to enshrine in legislation new social objectives for HNZC, which include assisting tenants to sustain their tenancies and being a "fair and reasonable landlord." These objectives will continue to apply to the new Housing and Urban Development Authority, if it proceeds. The government also proposes changing the presumption that HNZC will return surpluses to the Crown. While HNZC has paid dividends to the Crown in the past, we do not expect that it will make any such payments during the next few years.

HNZC's financial performance remains solid. We project that EBITDA, as a percentage of revenues, will average about 36% during the five-year period between financial years 2017 and 2021. HNZC's financial policies are prudent. Annual financial reports are produced on a consolidated basis, and are audited by a firm appointed by the Auditor-General of New Zealand. HNZC prepares statements of intent and annual statements of performance expectations that contain detailed medium-term financial and operational targets and are tabled in parliament. HNZC also provides its Crown minister with quarterly performance monitoring reports. Long-term debt is used only for capital expenditures, and not operating costs. After taking into account the effect of interest-rate swaps, about 79% of HNZC's borrowings are at a fixed rate of interest.

We expect HNZC's borrowings to rise during the next few years, though its debt profile should remain relatively strong. A key change from the past is that

HNZC, through its subsidiary HNZL, has begun issuing domestic bonds to meet the upfront capital cost of its building program. In June 2018, HNZL finalized a dual-tranche issuance of NZ\$250 million in five-year notes and NZ\$250 million in seven-year notes. HNZL forecasts its commercial term debt to grow to NZ\$2.9 billion by June 30, 2022, from NZ\$500 million as of June 30, 2018. HNZL also had NZ\$200 million of short-term commercial paper outstanding as of June 30, 2018, and we expect it to continually roll over about NZ\$150 million to manage its working capital requirements. HNZC's commercial borrowings are governed by a borrowing protocol set by the Crown's Minister of Finance and Minister for Housing and Urban Development. An updated borrowing protocol took effect from June 1, 2018, with the limit for commercial (i.e., non-Crown) debt raised to NZ\$3.05 billion from NZ\$1.08 billion.

Meanwhile, the HNZC group has an additional NZ\$1.94 billion in borrowings from the Crown. We expect that this figure will remain steady during the next few years, as Crown debt is rolled over at maturity. We forecast that HNZC's EBITDA-to-interest ratio will average about 4.6x and its debt-to-EBITDA ratio will average about 6.3x during financial years 2017 to 2021. These ratios incorporate all of the group's Crown and commercial debt. Our base-case forecasts are based on data available to us before the government's announcement on Nov. 24, 2018. We do not yet have details about how the new Housing and Urban Development Authority--if it is established--will operate and what its financial strategies will be.

HNZC's reporting requirements changed recently with the establishment of the government's new Ministry of Housing and Urban Development, which from Oct. 1, 2018, assumed the housing functions formerly undertaken by the Ministry of Social Development, the Ministry of Business, Innovation, and Employment, and the Treasury. We do not expect this change to have any material effect on HNZC's relationship with the Crown.

Our ratings on HNZC are equalized with those on its owner, the New Zealand government, reflecting our view that there is an almost-certain likelihood that the Crown would provide timely and sufficient extraordinary support to HNZC in the event of financial distress. Our assessment is based on our view of HNZC's:

- Critical role, given that its main purpose is mandated by the Crown and it operates on behalf of the Crown to provide a key public service (i.e., the provision of social housing to the most vulnerable). We believe that recent reforms--such as the cancellation of the stock transfer program and the government's proposal to enshrine social objectives in HNZC's governing legislation--further cement this role.
- Integral link with the Crown, due to its status as an agency that can be considered an extension of the government. Further, the Crown is responsible for appointing members of HNZC's board, and it provides a significant proportion of HNZC's current debt.

Liquidity

We view HNZC's liquidity position as strong. Sources of liquidity during the 2018-2019 financial year include:

- Forecast cash generated from continuing operations (net of interest payments) of NZ\$324 million.
- Cash and liquid investments of NZ\$671 million.
- Proceeds from asset sales of NZ\$41 million.
- Undrawn committed bank facilities of NZ\$350 million.

Uses of liquidity include:

- Our forecast of capital expenditure of NZ\$1,337 million.
- Maturing Crown loans of NZ\$127 million.
- Maturing commercial paper of NZ\$200 million.

HNZC has sources of liquidity of NZ\$1,386 million to cover uses of liquidity of NZ\$1,664 million, resulting in a liquidity coverage ratio of 0.83x. We consider that HNZC also benefits from exceptional access to external liquidity through the Crown's debt management office. As noted above, the Crown has historically provided all of HNZC's debt funding, and we expect that it would resume doing so in the event of capital markets stress. HNZC manages its debt maturity profile so that no more than 25% of total debt matures in any 12-month period.

Outlook

The positive outlook on HNZL reflects that on the sovereign, meaning that we could raise the ratings on both New Zealand and HNZL within the next two years.

Our ratings and outlook on HNZL also reflect our expectation that HNZC's role will remain critical and its link to the Crown will remain integral during the next two years. Consequently, our ratings and outlook on HNZL and HNZC will continue to be equalized with those on the New Zealand government.

We could lower our local-currency long-term ratings over the next two years if we perceive HNZC's role or link to the Crown to be weakening. This might occur, for example, if HNZC were amalgamated into the proposed Housing and Urban Development Authority and the new entity's strategies or governance are such that we no longer believe it plays a critical role or has an integral link to the Crown.

Table 1

| Housing New Zealand Key Statistics | | | | | |
|--|-------------------------------|--------------|---------------|---------------|---------------|
| | --Year ended June 30-- | | | | |
| (Mil. NZ\$) | 2017a | 2018a | 2019bc | 2020bc | 2021bc |
| Number of units owned or managed | 63,000 | 64,000 | N.A. | N.A. | N.A. |
| Vacancy rates (% of rent net of identifiable service charge) | 2.8 | 1.8 | N.A. | N.A. | N.A. |
| Arrears (% of rent net of identifiable service charge)* | 1.3 | N.A. | N.A. | N.A. | N.A. |
| Revenue§ | 1,317 | 1,326 | 1,490 | 1,543 | 1,875 |
| Share of revenue from nontraditional activities (%) | 9.9 | 6.0 | N.A. | N.A. | N.A. |
| EBITDA† | 453 | 512 | 531 | 578 | 624 |
| EBITDA/revenue (%) | 34.4 | 38.6 | 35.6 | 37.5 | 33.3 |
| Interest expense | 87 | 84 | 117 | 152 | 186 |
| Debt/EBITDA (x) | 4.3 | 5.2 | 6.6 | 7.7 | 7.6 |
| EBITDA/interest coverage** (x) | 5.2 | 6.1 | 4.5 | 3.8 | 3.4 |
| Capital expense‡ | 586 | 957 | 1,337 | 1,267 | 1,206 |
| Debt | 1,969 | 2,653 | 3,523 | 4,423 | 4,724 |
| Housing properties (according to balance sheet valuation) | 24,922 | 26,700 | 27,792 | 29,280 | 30,435 |
| Loan to value of properties (%) | 7.9 | 9.9 | 12.7 | 15.1 | 15.5 |
| Cash and liquid assets | 528 | 671 | 500 | 491 | 266 |

*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.

Table 2

| Housing New Zealand Ltd. – Ratings Score Snapshot | |
|--|---|
| Enterprise profile | 2 |
| Industry risk | 2 |
| Economic fundamentals and market dependencies | 1 |
| Strategy and management | 2 |
| Asset quality and operational performance | 1 |
| Financial profile | 2 |
| Financial performance | 3 |
| Debt profile | 1 |
| Liquidity | 3 |
| Financial policies | 1 |

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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

- New Zealand Outlook Revised To Positive On Improving Fiscal Position; 'AA+' LC And 'AA' FC Ratings Affirmed, Jan. 31, 2019
- Housing New Zealand Corp. Outlook Revised To Positive Following Similar Action On New Zealand; Ratings Affirmed, Jan. 31, 2019

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

| | To | From |
|--------------------------|-------------------|-----------------|
| Housing New Zealand Ltd. | | |
| Issuer Credit Rating | | |
| Foreign Currency | AA/Positive/A-1+ | AA/Stable/A-1+ |
| Local Currency | AA+/Positive/A-1+ | AA+/Stable/A-1+ |
| Housing New Zealand Ltd. | | |
| Senior Unsecured | AA+ | |
| Short-Term Debt | A-1+ | |
| Commercial Paper | A-1+ | |

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