French Social Housing Operators' Credit Quality Can Withstand Rent Cuts And Sector Reform

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Key Takeaways

- We believe that French social housing operators benefit from low industry risk, reflecting a supportive institutional framework displaying strong regulation and government controls and a track record of public-sector financial support where needed.
- This is despite the French central government's decision to cut social housing rents from 2018, to offset lower housing allowances to tenants.
- While affecting their financial performance and debt metrics, we expect rent cuts to remain manageable for the housing operators, which we expect will continue to display strong EBITDA margins through 2020.
- We acknowledge that additional reforms under the ELAN law passed in November 2018 may strengthen the sector financially, with mergers resulting among larger social housing operators and increasing funding diversification, potentially prompting bond issuances and recourse to commercial paper programs.
- Rent cuts and sector reform could, however, also prompt social housing operators to increase their exposure to nontraditional and volatile market-oriented activities, which if sizable we would view as credit negative.

The Impacts Of Rent Cuts And Sector Reform Should Be Manageable, Though Financial And Debt Metrics Will Deteriorate

Under its finance bill for 2018, the French central government unexpectedly announced its decision to reduce some housing allowances to tenants, with almost matching rent cuts for social housing operators, some of which took effect in 2018 and others in 2020. This will leave tenants broadly unaffected, but operators significantly worse off.

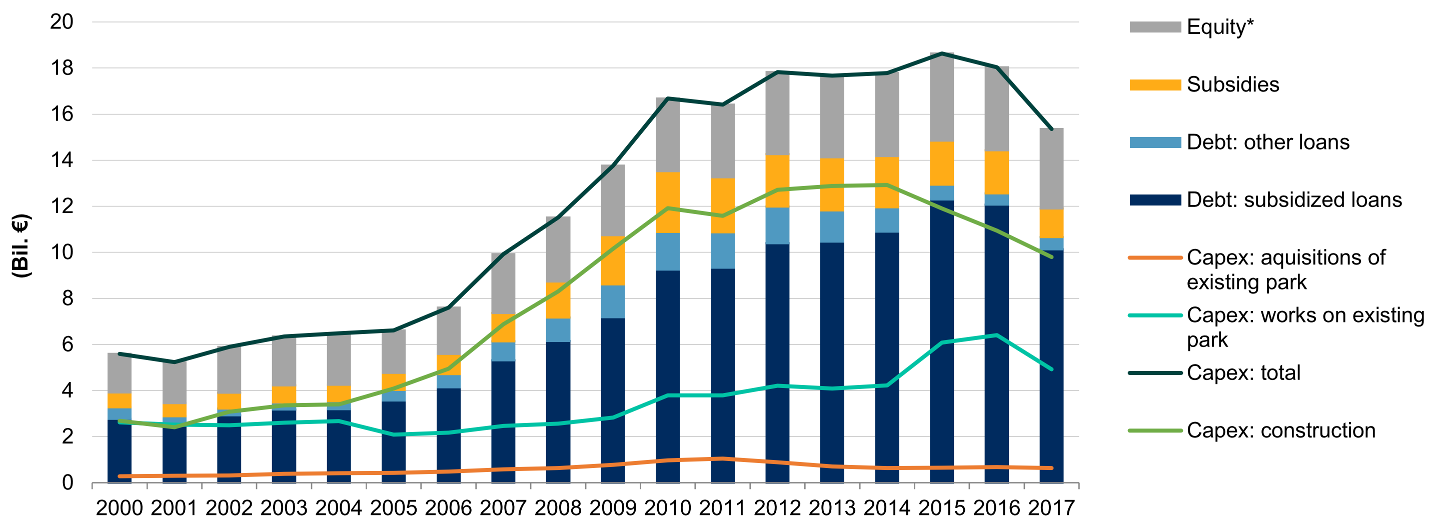
S&P Global Ratings expects the impact of rent cuts to be material from 2018, at about €800 million for the French social housing sector, which is about 4% of social housing rents and about 5.5% in real terms. While operators may be able to offset some of the impact through cost controls or cuts, we expect that rent cuts and the freeze on rents for 2018 have materially reduced their

capacity to self-finance capex. We also note that rent cuts will be cut further in 2020, putting total annualized costs at €1.5 billion or over 7% of social rents.

Social housing operators will therefore need to rethink their operational and financial strategy under the new rent regime, as some existing or planned housing programs may no longer look viable. In addition, state and local governments' subsidies may also further decline. As a result, capex seems the first at risk, whether for new developments, the acquisition of existing dwellings, or maintenance of existing assets, with potential longer-term negative impacts on the asset bases of the operators.

Chart 1

Debt Funds Most Of French Social Housing Operators' Capex



*Funds from operations, net of debt repayment and including asset sales and capital injections. Sources: CGDD, Compte national du logement 2017 (2018), S&P Global Ratings.

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However, we expect rent cuts to prove financially manageable for the sector, reflecting generally strong EBITDA margins at 45%-50% of revenues over 2014-2016, though with wide disparities among social housing operators. We believe rent cuts would reduce EBITDA margins by about 5% in 2018 and again by about 4% in 2020, all other things remaining equal.

Under our base case, we have fully factored in those rent cuts in 2018 and 2020, however partly met by strong savings measures (including on purchasing, personnel, and general costs). As such, we therefore expect EBITDA margins to remain sound, at about 43% of revenues sectorwide by 2020 (exceeding 45% for private nonprofit social housing operators--Entreprises Sociales de l'Habitat, or ESHs--and 38% for public social housing operators--Offices Publics de l'Habitat, or OPHs--, though we also note that debt service is high, currently accounting for around 40% of rent revenues for the sector, and largely reflecting debt-funded capex.

The Evolution du logement, de l'aménagement et du numérique (ELAN) law, passed in November 2018, facilitates social housing dwelling sales to other providers--with an ambitious target of 40,000 unit sales a year (or about 1% of total sector stock). We consider this may push asset sales

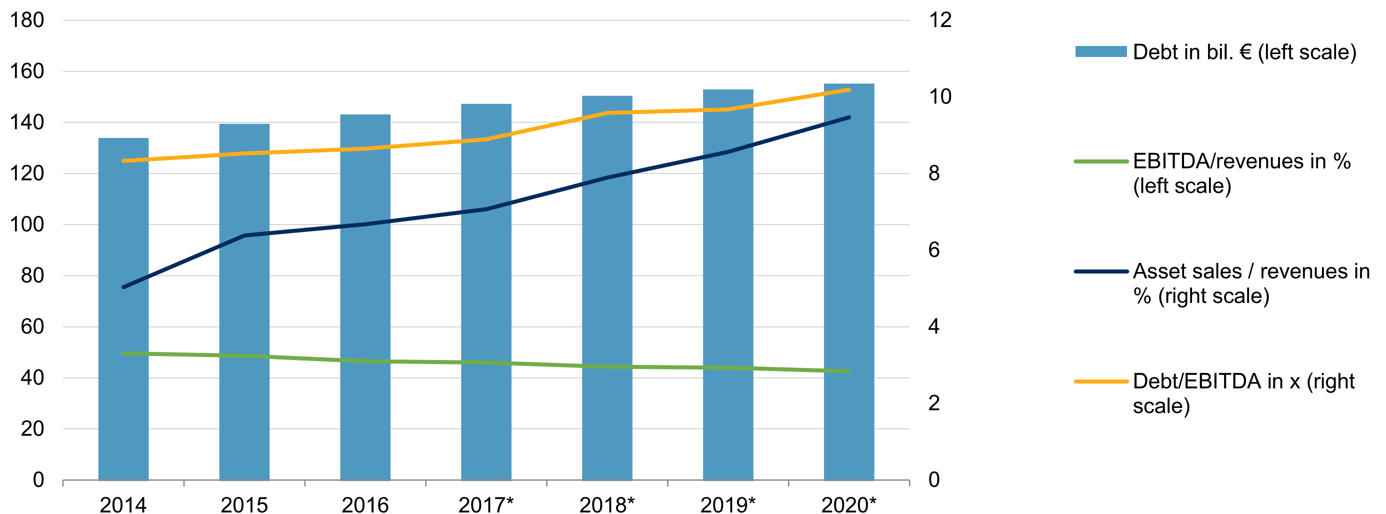
to over 9% in our base case for 2020 from less than 7% of revenues in 2016. We expect these sales will involve traditional activities and only marginally market-related activities. While potentially helping fund new projects, we note such asset sales will also reduce future cash generation for social housing operators--as they lose associated rent revenue flows.

Our base case also considers the French government's financial measures to soften the rent cut impacts. It notably instructed public finance institution Caisse des Dépôts et Consignations (CDC)--and Action Logement--to accompany the reform by providing additional funding to the sector. This will be through new subsidized 40-year loans (with 20-year grace periods for capital repayment for new construction), lengthening repayment schedules for parts of already drawn debt, and extending new short-term facilities (totaling €3 billion). Coupled with stable interest rates in 2018 and 2019 on most CDC loans, we expect this to limit interest charges and smooth out housing operators' debt repayment schedules. While providing some relief to the sector, these measures, however, fall short of offsetting rent cuts, and they will alter housing operators' capital structures, replacing self-funding of projects by new debt.

Factoring these elements and our expectation of a limited reduction in capex (-10% to about €15 billion a year) in coming years, we expect social housing operators' financial debt to grow more slowly than in recent years (by about an annual €3 billion, down from more than €4 billion in 2015/2017) and reach about €155 billion at end-2020. This would translate into an increasing debt burden to 10x EBITDA in 2020 (from about 8.5x in 2014-2016) and deteriorating EBITDA cover of interest charges at a still solid 3.5x, though down from just over 6x on average in 2014-2016.

Chart 2

Social Rents Cuts To Erode EBITDA And Increase Leverage, Despite Larger Asset Sales



*This is under our base case scenario. Sources: Ministère de la Cohésion des Territoires (2018) for 2014-2016 data, S&P Global Ratings calculations; S&P Global Ratings projections (base case scenario) for 2017-2020.
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Reform Push For Concentration Could Result Into Stronger Social Housing Sector

France's social housing sector is currently very fragmented, with a limited number of large operators (including two very large groups, Action Logement with over 950,000 dwellings and CDC Habitat with over 350,000 dwellings), alongside small- and midsize local players. We also note wide diversity in terms of financial and business/operational profiles, making the sector heterogeneous overall.

The ELAN law considers mergers among operators and eases processes for the creation of groups, with strong controls and monitoring as well as strategy definition at the group level, including shifting funding means and amalgamating companies within groups. We understand the government expects some efficiencies and economies of scale from larger and stronger groups. The ELAN law also sets conditions whereby the Housing Ministry may impose the takeover of an ailing, or too small, or inactive housing operator by selecting another operator that would acquire part or all its dwellings, with potential financial support from Caisse de Garantie du Logement Locatif Social (CGLLS) for the merger.

In our view, the reform could improve the sector's financial resilience, especially if it helps housing operators diversify their activity over a larger territory and better allocate their funding to projects in tense, economically vibrant areas. Sector consolidation looks to be on its way, as small and weaker operators are facing comparatively stronger financial pressure from rent cuts. We also note that voluntary mergers and partial acquisitions across the sector have started. We recently revised to stable (from negative) our outlook on social housing operator Maisons & Cites S.A. d'HLM (M&C; A+/Stable/--). This was in the wake of CDC Habitat purchase of a 34% stake in M&C in June 2018 from the regional public agency EPINORPA, which fully transferred the €150 million in cash proceeds to M&C as a nonrefundable grant funding future renovation programs, structurally supporting the company's liquidity position. (For more details, see: "French Housing Operator Maisons & Cites S.A. d'HLM Outlook Now Stable On Large Capital Injection And Solid Performance", Oct 30, 2018).

Larger groups and funding needs speak for increasing financial diversification

French social housing operators are currently almost fully funded from loans, with CDC accounting for about 78% of total sector debt, Action Logement for about 6%, and commercial and public French banks for the remainder (about 16%)--as bonds currently account for a negligible amounts. (Only a handful of entities have historically issued bonds, including M&C.) We note that some banks refinance their loans to the sector using covered bond vehicles, thanks to the public legal status and ownership of OPHs and to explicit debt guarantees extended by local governments to operators.

Larger social housing groups with larger funding needs may look to diversify their financing options by directly accessing the capital markets. They may seek partial funding diversification from CDC loans, more balanced exposure to fixed rates (most CDC loans are indexed to Livret A government-set short-term rates or at variable market rates), and changes to their maturity/repayment profile (to smooth out debt service and better match their cash inflows; most sector debt amortizes and bullet loans or bonds are limited). They may also look to develop their banking and investor bases.

While social housing operators are generally cash-rich, they have access to credit facilities (usually from commercial banks) that they can use as a bridge to already secured loans from the

CDC, to take advantage of more favorable financial terms, for instance before consolidating some long-term CDC loans. We note a handful of social housing operators have so far issued commercial paper ("NEU CPs") since 2017, and we expect new operators to join this market, taking advantage of very good financing conditions.

Higher exposure to nontraditional activities could be credit negative, as happened in the U.K.

As a side effect of the reform and rent cuts, and in a move to restore their margins, some French social housing operators may increase their exposure to nontraditional activities, including market-related activities such as development for sale or private rentals. If the move proved massive, we may then reassess our view of their industry risk, reflecting deteriorating quality of earnings that would be more volatile than traditional social rent revenues.

In doing so, we note that social housing operators would face strong competition from private operators, and that they would not benefit from subsidized loans for nontraditional activities. Local governments could also progressively shy away from providing new debt guarantees to entities and their projects if they saw the operators or the sector as more risky.

We have observed this situation in the U.K. recently, in the context of continued central government-initiated social rent cuts since 2016. In July 2018, we therefore reviewed downward our assessment of industry risk for some U.K. housing associations. We recognized swift and sometimes massive involvement in nontraditional activities, including outright sales and development for sale, with risk exposure that we considered as no longer commensurate with the low industry risk typically associated with a traditional social housing provider.

French Social Housing Operators Still Benefit From An Overall Very Supportive Institutional Framework

We assess industry risk for the French social housing sector as low. This is primarily due to the sector being countercyclical in nature and having strong government oversight. Social housing providers generally experience sustained demand for their core services in times of economic hardship, and demand typically remains strong throughout the business cycle, with limited competitive pressure generally. Moreover, social housing remains politically very sensitive and benefits from general cross-political party support.

Social dwellings (4.8 million in 2017) make up 17% of total dwellings in France, close to the share in the U.K. (18%) but much higher than in Germany (4%) or Italy (4%; source: Housing Europe, 2017 data). Social housing tenants account for 15% of French households. Given the social importance of services provided, we view the potential for high negative central government intervention on social housing operators as limited in France. We note that the state accompanied recent adverse cuts in social rents with a set of softening financial measures (see below). Likewise, we also see negative interference from local and regional governments (LRGs) as a remote risk for the sector, though they can exert direct influence though their ownership and control over OPH and their semipublic companies (SEM or SPL immobilières) active in the social housing sector, as well as through their land development authorization rights.

Favorable institutional settings, with strong regulation and controls, and very favorable funding terms from public financial institutions

French social housing operators benefit from an overall favorable institutional environment. Social housing tenants are usually eligible for special means-tested allowances dedicated to rent payments and paid by a national public agency (the National Family Fund or CNAF); these benefits are generally paid directly to landlords and social housing operators, thereby reducing rent payment risk. In 2017, social housing operators' tenants benefited from €7.7 billion of housing benefits, covering about 39% of social housing rents. Social housing operators are also exempt from income tax on their social housing activities, and benefit from property tax exemptions for many years, typically the first 25 years of renting activity.

Most social housing projects are eligible for very long-term (up to 40, exceptionally 50/60 years), subsidized (and generally amortizing) loans from Group Caisse des Dépôts et Consignations (CDC, AA/Stable/A-1+), one of the French state's financial arms. This explains why outstanding sector debt (about €143 billion at end-2017, Source: USH) is overwhelmingly with CDC (78% at end-2017, or €111 billion). Social housing operators can also access subsidized funding from Action Logement (€8 billion of outstanding loans at end-2017, or 6% of total sector debt). Action Logement collects a social contribution on wages ("participation des employeurs à l'effort de construction" or PEEC), the proceeds of which it uses to fund social housing projects through subsidies and long-term loans, under tight control from central government. We note that part of commercial bank loans to the sector are transferred to and refinanced through covered bond pools.

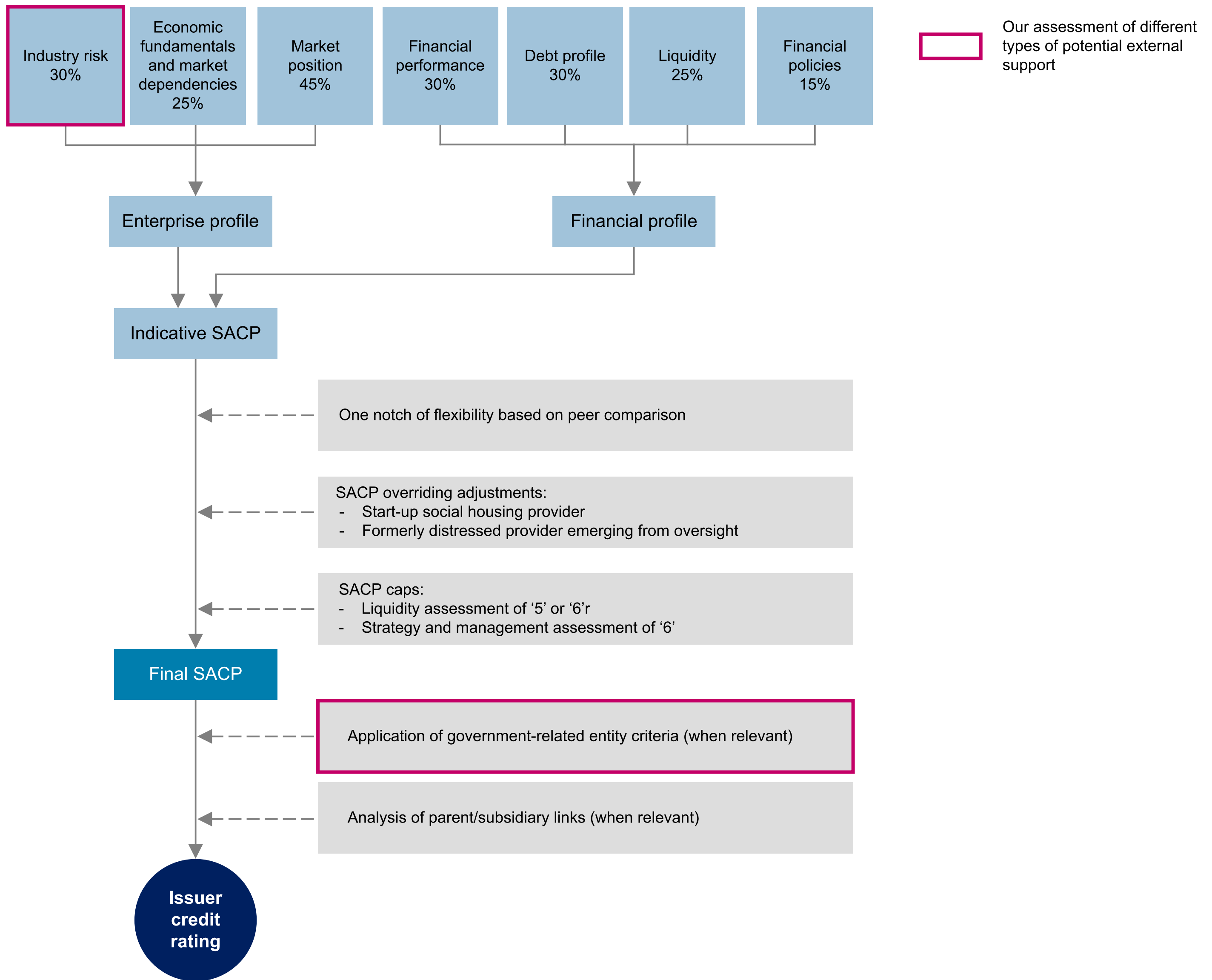
The French social housing sector is subject to strong supervision and financial controls by a dedicated central government agency (ANCOLS). In case of financial trouble, the state generally intervenes indirectly, through ad hoc subsidies from CGLLS--a central government agency funded by social housing operators and in charge of preventing financial troubles at social housing operators. It can also force mergers of troubled and financially sound operators. We understand that over 1998-2017 CGLLS extended supporting subsidies for €0.95 billion in total (just about 5% of social housing operators' rents in 2017). Public social housing operators are also subject to controls from the national/regional audit courts.

Acknowledging Potential External Support When And Where It Belongs

S&P Global Ratings considers regulation, state monitoring, sector support and rescue mechanisms, and funding from CDC and from Action Logement as systemwide strengths, which we capture in our "industry risk assessment" for all social housing operators. This assessment benefits the stand-alone credit profile (SACP, see chart 1).

In addition, we assess the potential for additional uplift from extraordinary, entity-specific support from LRG parents or debt guarantors, based on our criteria for rating government-related entities, and this can end up in an uplift to the final rating from the SACP (see for instance, the City of Lyon's housing semipublic company SACVL: "French Social Housing Operator SACVL 'A' Rating Affirmed; Outlook Stable," Jan. 31, 2018).

Determining The Issuer Credit Rating On A Social Housing Provider



SACP--Stand-along credit profile.

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On top of systemic support, OPH can benefit from ad hoc extraordinary financial support

Supporting our assessment that extraordinary support would generally stem from LRGs, we have also observed that French LRGs also generally complement support that CGLLS provide--through ad hoc grants as part of a financial recovery plan.

Public (OPH, SEM, and SPL immobilières) and ESH (private nonprofit) French social housing

operators usually benefit from guarantees from LRGs on their debt and bond issuances, for up to 100% of their amounts. The guarantee can be joint and several, with various LRGs guaranteeing a loan or bond. CDC generally requires LRG guarantees (or guarantees from CGLLS) to extend its subsidized loans. If LRGs do not extend guarantees, then the public fund CGLLS can, though this comes at a cost for the operators and generally concerns either weak LRGs or weak social operators.

Most large French LRGs (cities, intercities, and departments) generally control OPHs, public-law social housing operators. OPHs accounted for 41% of the total social housing supply in France, with over 2.24 million rented units (on par with private non-profit housing providers--ESH-- at 2.22 million) as of end 2017, with 246 OPHs nationwide (versus 217 ESH).

We view OPHs as government-related entities (GREs) that may receive extraordinary support from their controlling local government in case of need. In case of extreme financial troubles, being a local public agency, an OPH can be dissolved (though it cannot legally go bankrupt) and its assets and liabilities would revert to their public parent. In our view, this provides strong incentives for public parents to oversee their OPHs--though such monitoring is sometimes distant.

We would not consider the potential likelihood of support from an OPH's public parent on a systemic and systematic basis. This is because we would expect the importance or role of an OPH to be potentially very different among public parents, as we would for their links, controls, and interactions with the supporting LRG. The same is true for semipublic companies (SEM or SPL) active in the social housing sector—an example being SACVL (A/Stable/--), for which we see a high likelihood of extraordinary support from its controlling public parent, the City of Lyon (AA/Stable/A-1+) in case of financial distress.

Meanwhile, we also view ESHs as nonprofit social housing providers, as they share most characteristics of OPHs, including strong regulation and public oversight, and access to system support and subsidized debt funding. While ESHs can distribute dividends to their shareholders, we note that regulation greatly limits their amount and this speaks to their nonprofit nature, in our view.

However, we generally do not consider ESHs as GREs, and we generally view the potential for extraordinary support from LRGs for ESHs as far less certain than for OPHs, primarily because of their generally private ownership. We therefore analyze extraordinary support on a case-by-case basis, and we generally look primarily at potential support where we view a form of control or ownership by LRGs or their willingness to support or track record of timely support, or both. This is the case for M&C, where we see a moderately high likelihood of extraordinary support from the Region of Hauts-de-France (A+/Positive/A-1), in case of need. We think that M&C's group's role to the region will remain important, as one of the largest regional social housing providers, despite recently reduced links with the region, after regional public agency EPINORPA's disposal of 34% of M&C's capital in June 2018.

Related Criteria And Research

Related criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014

Related research

- French Housing Operator Maisons & Cites S.A. d'HLM Outlook Now Stable On Large Capital Injection And Solid Performance, Oct. 30, 2018
- French Social Housing Operator SACVL 'A' Rating Affirmed; Outlook Stable, Jan. 31, 2018
- French Public Financial Institution Groupe Caisse des Depots et Consignations Affirmed At 'AA/A-1+'; Outlook Stable, April 16, 2018
- Why We Lowered The Ratings On Five London-Based Housing Associations, July 30, 2018
- How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers, Aug. 6, 2018

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