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Weekly Credit Brief
May 31 - Jun 06 2022

Deterioration in credit outlook looms over the UK home construction sector as inflationary pressures build

by Elaine Uy

- **NUS-CRI Agg Forward 1-year PD suggests a worsening in the credit outlook of UK homebuilders resulting from the potential further increase in inflation and its effect on the sector's profitability**
- **Discontinuance of government support on purchase of new homes is likely to decrease demand, adding to the macroeconomic woes faced by the sector**

The UK government, which is winding down its Help to Buy scheme[1] (HTB) on Mar-2023, has recently brought forward the deadline for new applications for prospective homebuyers. The move came amidst the country's current battle against its record-high inflation that has pushed consumer prices up by 9% YoY in Apr-2022 and had prompted the Bank of England (BoE) to impose its fourth consecutive interest rate hike since Dec-2021. Resultantly, this would push mortgage rates up and discourage new home acquisitions. Earlier in Feb-2022, NUS-CRI Aggregate (median) 1-year PD (Agg PD) for the UK home construction sector[2] (UK homebuilders) saw an upward shift as the Russia-Ukraine war squeezed global supply chains and pushed up input costs (See Figure 1a). With regulatory changes and macroeconomic conditions further increasing costs for UK homebuilders while simultaneously adversely impacting consumer demand, credit risk could potentially continue increasing in the near term as can be seen in the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[3]) (See Figure 1b).

Figure 1a (LHS): NUS-CRI Agg 1-year (median) PD for UK homebuilders from Jun-2021 to Jun-2022, with reference to PDiR2.0 bounds[4]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for UK homebuilders as of Jun-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

The benefits provided by HTB to prospective homebuyers, in conjunction with the low borrowing costs, had sustained demand for housing even as house prices increased (See Figure 2a). With a solid source of revenue and cash flows, credit risk for UK homebuilders had remained low (See Figure 1a). However, the discontinuance

[1] Help to Buy: Equity Loans scheme is a government financial assistance introduced in Apr-2013 to assist eligible applicants to purchase a new build home through a government equity mortgage secured on the home. The scheme makes newly-built homes available to prospective homebuyers who are cash-constrained by requiring only 5% in downpayment. The government would also provide up to 20% of the value of the property which is repayable in 25 years or when the property is sold in the future.

[2] Home construction sector includes homebuilding and building products subsectors.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[4] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

of HTB is expected to leave a substantial gap in demand for new homes, having supported 48.1% of new home sales since its inception in 2013. Although considering the current macroeconomic environment, even the housing demand that is not generated by HTB might also potentially decrease. The lost demand puts pressure on UK homebuilders to lower the selling prices of completed builds, which could dampen profitability prospects in the short-term or until the macroeconomic condition improves. Along with the pressure on household budgets because of surging prices, the government has also mandated an increase in national insurance contributions which would further squeeze the disposable incomes of households. Moreover, the BoE has raised the interest rate four times since Dec-2021 and is expected to push the rate beyond its current level of 1% as it looks to contain rampant inflation. However, this decision would mean that the borrowing costs will be higher for mortgage borrowers, compounding the effect of the discontinuance of HTB. As of Apr-2022, mortgage approvals have dropped to their lowest level since the first wave of the pandemic, showing the initial effect of rising mortgage rates on demand which could slow or stagnate home sales.

The heightened house prices were resultant partially of the surging costs of construction materials[5], which have increased by 22.0% YoY in Apr-2022 owing to the sharp rise in steel and timber prices and supply chain disruptions. To preserve their margins, homebuilders were compelled to pass on some of the excess costs to consumers. However, to encourage new home acquisitions without government support, the homebuilders might need to absorb more of the input costs to lower prices to affordable levels. Moreover, the additional costs necessary to comply with the new regulations to support the government's direction toward net-zero carbon emissions[6], which will be fully implemented in Jun-2022, could also further strain margins going forward.

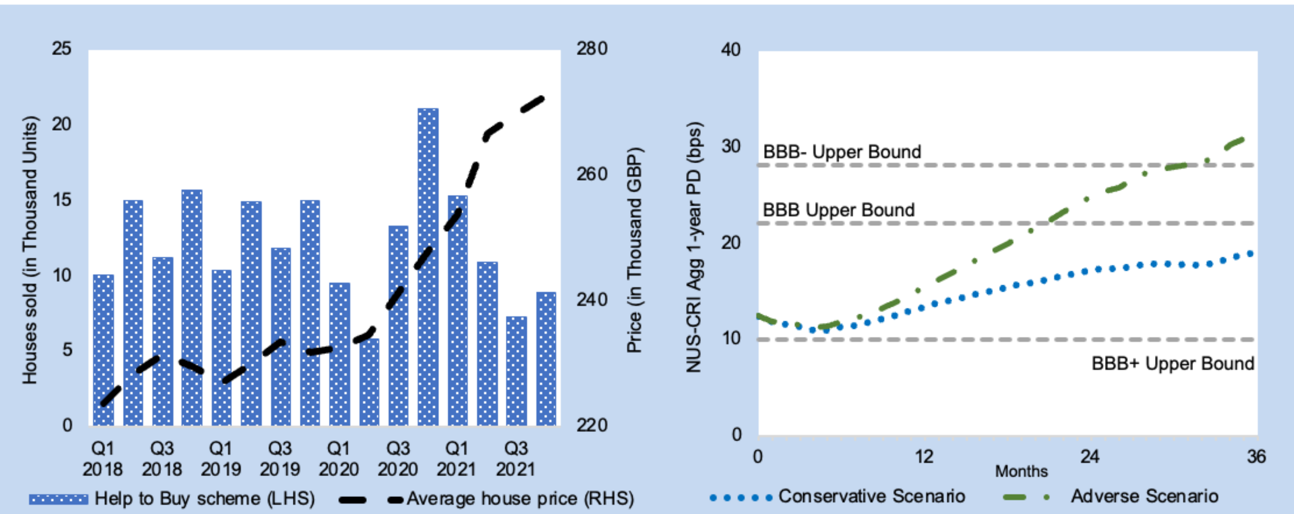

Figure 2a (LHS): Quarterly new home acquisitions under HTB (in thousand units) from Q1 2018 to Q4 2021; Quarterly average house prices from Q1 2018 to Q4 2021 (in thousand GBP). Figure 2b (RHS): Stressed NUS-CRI Agg 1-year PD of UK homebuilders based on conservative and adverse scenarios[7] with reference to PDiR2.0 bounds. *Source: Office of National Statistics, Department of Levelling Up, Housing & Communities, NUS-CRI, BuDA v3.3.0*

While the UK homebuilders' operations were impacted by low demand during the height of COVID-19, operating margins had been restored close to pre-pandemic levels[8] in 2021 due to government incentives[9]. However, going forward, a squeeze in profitability might translate to a restriction in their liquidity position considering that the median cash cycle for the sector extends to more than 1 year. This inherent operational limitation of the sector might limit the ability of UK homebuilders to service near-term debt, although, on a positive note, the sector's median total debt to total capital had remained low at 8.9%[10] in 2021. Should the UK homebuilders require additional financing to support their operations or refinance existing debts, they will be met with higher borrowing costs as these respond to monetary tightening by the BoE. To measure the impact of movements in

[5] Energy prices are likely to remain high because of Europe's high dependency on Russian oil and gas. Consequently, costs of materials that require intensive energy inputs, such as construction materials, are also likely to continue rising.
[6] The Future Homes Standard sets out energy and ventilation requirements to mitigate against overheating and improve the energy efficiency of new homes, which may require a change in the processes or materials used.
[7] Under the conservative scenario, interest rates increase by 25bps QoQ until it reaches 3%, while house prices plateau for the rest of 2022 then decrease constantly by -0.5% QoQ. Under the adverse scenario, interest rates increase by 25bps QoQ until it reaches 3%, while house prices similarly surge by 5% QoQ for the rest of 2022, slowly taper throughout 2023 until it reaches 0% then remain constant. The scenarios are designed to simulate the impact of tightening monetary policy in the UK on borrowing costs and the corresponding pricing adjustments of homebuilders to stimulate demand.
[8] Median annual operating margin for UK homebuilders for 2021 is 10%, which has increased from 7% in 2020; compared to 11% pre-pandemic level; data from Bloomberg.
[9] The UK government temporarily reduced stamp duty tax land rates for residential properties purchased from Jun-2020 to Sep-2021 to boost the property market.
[10] Data from Bloomberg.

interest rates and house prices, stress tests can be conducted using the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA[11]). As shown in Figure 2b, in the conservative scenario that interest rates continue to rise while house prices stagnate and eventually decline, median credit risk for UK homebuilders is seen to gradually increase. This result suggests that the anticipated increase in demand following a reduction in house prices may not be fully realized due to higher borrowing costs, thus keeping the profitability strained and PD elevated. Further, in the adverse scenario that house prices surge alongside interest rates, the negative impact on demand and profitability will likely be felt sooner, translating to a worsening trajectory of the credit outlook for the sector.

Surging inflation, higher borrowing costs, and rising regulatory requirements collectively pose challenges that could test the effectiveness of the homebuilders' revenue-generating and liquidity management abilities as these factors also hinder demand. Nonetheless, the sector's generally healthy capital structure provides a buffer against mounting pressures and economic shocks, allowing for a likely maneuver towards recovery.

[11] The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

Credit News

Pressure builds on riskiest corner of US junk bond market

Jun 05. Soaring inflation rates and increasing interest rates have soured investor sentiments causing a massive sell-off in the US junk bond market. Triple C and below-rated bonds, which had generally outperformed double B bonds, now report an upturned trend with returns amounting to negative 2.8 percent as compared to 1.3 percent for double B bonds. This follows the apprehension stemming from the inability of several triple C-rated companies to match analyst expectations for Q1 2022. Overall, despite the attractive returns on junk bonds, investor demand is predicted to remain low as they remain wary of the economic outlook. (FT)

Zombie firms face slow death in US as era of easy credit ends

May 31. Troubled firms such as AMC and Carnival Corp. derived immense benefits from the Fed's ultra-loose monetary policy and ease of access to capital markets during the pandemic. However, they are now facing turbulent times as their access to capital dries up as investors stay away in anticipation of a recession. The few firms which manage to secure funding are now facing high borrowing costs as the Fed continues on its course of monetary tightening. To add to their woes, supply chain issues have significantly elevated their cost of inputs pushing them further to the brink of default. (Bloomberg)

Canada banks issue flurry of bonds as stagflation fears mount

Jun 03. As of Jun 2022, driven by macroeconomic factors, Canadian banks have already surpassed the total amount of capital raised via bond markets in 2021. The banks have raised approximately CAD 168bn in 2022 YTD as compared to CAD 153bn in FY 2021. The Bank of Canada warned of tighter monetary conditions ahead as it raised interest rates to combat record-high inflation levels. Against this backdrop, ensuring stable liquidity and TLAC ratios takes precedence for banks and are key factors driving the increase in bond issuances. Additionally, banks are also selling covered bonds and deposit notes in a bid to optimize funding costs. (Bloomberg)

U.S. corporate bonds post first positive monthly return this year

Jun 01. The outlook of US corporate bonds has steadily improved as both, the ICE BofA U.S. corporate index (.MERC0A0) and the ICE BofA U.S. High Yield Index (.MERH0A0) reported their first positive return since the start of the year. The improved investor confidence follows expectations of easing inflation rates and expectations of Fed softening its stance, which would in turn improve companies' ability to meet debt obligations. Benchmark 10-year Treasury yields have fallen by 10 basis points in May as compared to April, which saw yields reaching record highs of 3.2%. (Reuters)

China raises pressure on banks to help struggling developers

Jun 02. As the number of developers that have defaulted on or extended debt obligations mounts in China, banks are reluctant to increase their exposure to the sector. People's Bank of China has called for meetings with banks in multiple cities to assess why loans have slowed and how regulators can help. The dearth of lending isn't entirely a supply issue, instead the risk of weak sales has made the private builders reluctant to borrow for new housing projects. Additionally, the country's deepening anti-corruption drive is further restraining banks' lending appetite. (Bloomberg)

Main Street investors break records in rush for U.S. government bonds (WSJ)

Russia's 'failure to pay' bond interest triggers credit default swaps (FT)

Shimao grace period for USD 900mn trust products lapses (Bloomberg)

Regulatory Updates

ECB to firm up plans to ward off bond market stress

Jun 06. With the ECB on course to raise rates for the first time in a decade, policymakers have reiterated their commitment to support weaker economies if they are hit by a sharp selloff in debt markets. The ECB is expected to pass a proposal to create a bond-buying program that would attempt to stabilize borrowing costs for members. When it comes to monetary tightening, ECB has lagged behind its peers. Many policymakers believe that before initiating the cycle of rate hikes, it may be essential to provide support to bond markets. In response to the proposal, the yield on the benchmark 10-year Italian government bond fell by 0.1 percentage points. (FT)

Top Fed official warns half-point rate rise may be needed in September

Jun 03. Lael Brainard, a top Fed official, stated that unless inflation shows signs of cooling, the Fed may have to stick to half-point rate hikes until September. Her comments follow a recent half-point raise by the Fed, the first of its kind in 22 years. The market is already pricing in at least 2 half-point raises in June and July, an additional half-point increase in September would be the fourth such raise in a year. The severe monetary tightening may hurt the labor market and GDP growth, however, Lael Brainard, expects the outlook of the US to be strong. Simultaneously, the Fed has also begun reducing its balance sheet which could translate into a two to three percentage points increase in the future. (FT)

Australia's solid economic momentum suggests faster rate hikes (Bloomberg)

BOJ's Kuroda sees progress on prices while sticking with easing (Bloomberg)

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