S&P Global
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Research Update:

Sovereign Network Group Ratings Lowered To 'A-'; Outlook Stable

November 21, 2024

Overview

- We project that U.K.-based social housing provider Sovereign Network Group (SNG) will continue to partially debt-fund the development of new homes while increasing investments in existing homes.
- We forecast SNG's debt and interest payment costs will increase more than we had assumed and that the projected recovery will be more modest and protracted.
- We therefore lowered our long-term issuer credit rating on SNG to 'A-' from 'A'. The outlook is stable.

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Rating Action

On Nov. 21, 2024, S&P Global Ratings lowered its long-term issuer credit rating on SNG to 'A-' from 'A'. The outlook is stable.

At the same time, we lowered our issue rating on Sovereign Housing Capital PLC's senior secured bonds to 'A-' from 'A'. Sovereign Housing Capital is a special-purpose finance vehicle set up for the sole purpose of issuing bonds and lending the proceeds to SNG, and we view it as a core subsidiary of SNG.

Outlook

The stable outlook reflects our view that pressure on financial indicators, stemming from larger investments in existing homes and partially debt-funded development spend, is balanced by SNG's focus on building rent-generating homes, which should lead to a steady increase in revenues and adjusted EBITDA. We also consider the group has built-in flexibility in its investment plans, which if applied effectively, should prevent a further weakening of the group's financial indicators.

Downside scenario

We could lower the rating if investments in existing homes increase further, and cost inflation has a significant and detrimental impact on SNG's adjusted EBITDA. Pressure on the ratings could also stem from a step-up in new home development. We think this could lead to materially higher debt uptake than projected, which in combination with higher costs could lead to a material weakening of the group's debt metrics.

Upside scenario

We could raise the ratings if we saw evidence of SNG taking steps to effectively mitigate the impact of economic and regulatory external factors. We consider this could lead to a gradual improvement in the group's financial indicators, such that the group's S&P Global Ratings-adjusted nonsales EBITDA interest coverage strengthens to 1.25x and debt to adjusted nonsales EBITDA falls below 20x on a sustained basis, all else being equal.

Rationale

The downgrade of SNG reflects our projection that the group's partially debt-funded development program, along with a higher-than-previously-assumed level of investments in existing homes, will prevent a material recovery in the group's financial indicators over the next two years.

We consider SNG focuses on building homes predominantly for general needs and shared ownership, which will result in steadily rising rental revenues for the group. This will, in our view, partially mitigate the impact of the group's investments to enhance the quality of existing homes and make them more energy efficient. SNG also has a disposal program that we project will bring in ample additional funding, along with solid grant funding to support its development plan.

However, we project SNG will need additional debt funding to cover its capital expenditures, and forecast the group's debt and interest payments will steadily increase through fiscal year 2027 (ending on March 31). While we still think the group's credit metrics may strengthen, the recovery will be delayed and more modest than previously assumed.

Enterprise profile: Supported by a large asset base and contained sales risk, but the investment strategy has resulted in a sustained weakening of credit metrics

SNG benefits from generating most of its earnings in the predictable and countercyclical social housing sector, supported by a solid market position and generally cautious approach to sales risk. We assume SNG's sales risk will be contained at less than one-third of turnover, supported by the group's consistent strategy and solid risk management. SNG owns and manages 86,000 homes, which enables the group to better withstand external shocks compared to smaller social housing providers.

The group continues to experience strong demand for its properties. SNG's average social and affordable rents are just above 50% of the prevailing market rent in the regions in which it operates--across London and the south of England. While we consider the group's average vacancy rates of 1.6% over the past three years to be on par with the rest of England's social housing sector, we understand that voids may increase as SNG focuses on further enhancing the quality of its homes before reletting them.

We note SNG continues to work on enhancing the energy efficiency of all its homes, aiming to achieve an Energy Performance Certificate (EPC) level C by 2030. Approximately 73% of its stock is already at EPC C or above. We understand most of its remaining homes are at EPC D, which should enable the group to meet its target without incurring higher energy efficiency costs than those already included in their plans. We also note SNG's new homes are developed at EPC B or above, further supporting the group's strategy to bring all homes to a solid energy efficiency level.

In our view, SNG's board and executive team possess solid experience in managing social housing providers, supported by strong governance and treasury practices. However, we consider the group's strategy to deliver on a relatively large new homes development plan while increasing investments in existing homes has resulted in a sustained weakening of its credit metrics. That said, we do not anticipate further weakening beyond our base case because management has built-in flexibility regarding investments in existing and new homes. We understand a significant part of SNG's development program for fiscal years 2026 and 2027 remains uncommitted. Furthermore, the group's planned investments in existing homes include provisions and potential costs that could be deferred to later years if needed.

We assess the regulatory framework under which registered providers of social housing in England operate to be strong (for more information see "Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks," published Oct. 23, 2023, on RatingsDirect).

Financial profile: The risk of further weakening financial indicators is balanced by built-in investment flexibility for existing and new homes

While we continue to forecast a recovery of the group's S&P Global Ratings-adjusted EBITDA, we now consider this recovery has been delayed and is more modest than we previously forecasted. We think the group's adjusted EBITDA margins have structurally weakened, mainly due to a higher level of investments in existing homes from fiscal year 2025. While rental revenues are forecasted to steadily increase and cost inflation is easing, we project the group's adjusted EBITDA margins will remain just above 20% through March 31, 2027 (fiscal 2027), whereas we previously assumed margins would strengthen to 24% in fiscal 2026.

At the same time, we consider that the group's debt metrics have structurally weakened due to its ongoing reliance on debt to partially fund new home development. We project the group's debt and interest payments will steadily increase through fiscal 2027 and forecast its adjusted nonsales EBITDA interest coverage and debt-to-adjusted nonsales EBITDA ratios will remain at about 1x and 25x, respectively, through fiscal 2027. We estimate SNG's issuance of a £400 million fixed-rate bond in January 2024 reduced its proportion of variable-rate debt to just over 10% as of March 31, 2024, down from 20% a year earlier. We view this positively since a larger proportion of fixed-rate debt provides better visibility and predictability of future interest costs.

We consider SNG's liquidity position to be strong. This is based on a liquidity ratio of 1.5x. We now think SNG's access to external funding is strong, underpinned by SNG's solid bond issuances and private placements as well as its broad and diversified banking group. We forecast liquidity sources of about £1.5 billion--mainly via cash from operations after adding back the noncash cost of sales, as well as cash and undrawn available facilities, grant receipts, and proceeds from fixed asset sales. This compares with liquidity uses of about £1 billion--primarily capital expenditure, interest, and principal repayments.

Government-related entity analysis

We think there is a moderately high likelihood that SNG would receive timely extraordinary government support if needed. This leads us to apply a one-notch uplift to the stand-alone credit profile to derive the issuer credit rating. Since one of the key goals of Regulator of Social Housing's (RSH) is to maintain lender confidence and low funding costs across the sector, we think it is likely that the RSH would step in and try and prevent a default in the sector. We base this view on previous records of the RSH mediating mergers or arranging liquidity support from other registered providers in cases of financial distress and think this would apply to SNG.

Selected Indicators

Table 1

Sovereign Network Group--Financial statistics

	--Year ends March 31--				
Mil. £	**2023a**	**2024a**	**2025bc**	**2026bc**	**2027bc**
Number of units owned or managed	84,943.0	86,379.0	87,644.0	88,764.0	89,970.0
Adjusted operating revenue	680.2	697.5	792.8	814.4	852.6
Adjusted EBITDA	157.9	168.4	168.0	166.4	190.9
Nonsales adjusted EBITDA	142.8	153.9	155.8	154.6	177.8
Capital expense	432.6	468.0	711.1	822.3	754.9
Debt	3,429.5	3,623.1	3,893.1	4,231.1	4,511.1
Interest expense	121.7	147.3	148.7	154.9	165.4
Adjusted EBITDA/Adjusted operating revenue (%)	23.2	24.1	21.2	20.4	22.4
Debt/Nonsales adjusted EBITDA (x)	24.0	23.5	25.0	27.4	25.4
Nonsales adjusted EBITDA/interest coverage(x)	1.2	1.0	1.0	1.0	1.1

a--Actual. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Sovereign Network Group--Ratings score snapshot

	Assessment
Enterprise risk profile	3
Industry risk	2
Regulatory framework	3
Market dependencies	2
Management and governance	3
Financial risk profile	4
Financial performance	4

Table 2

Sovereign Network Group--Ratings score snapshot (cont.)

	Assessment
Debt profile	5
Liquidity	2
Stand-alone credit profile	bbb+
Issuer credit rating	A-

S&P Global Ratings bases its ratings on nonprofit social housing providers on the seven main rating factors listed in the table above. Our "Methodology For Rating Public And Nonprofit Social Housing Providers," published on June 1, 2021, summarizes how the seven factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing Providers, June 1, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- The Autumn Budget Kicks Off A Funding Regime Revision For U.K. Public Sector Entities, Nov. 5, 2024
- U.K. Social Housing Providers' Financial Capacity Shrinks On Investment Needs, Nov. 4, 2024
- Non-U.S. Social Housing Providers Ratings Risk Indicators: Ratings Pressure Has Eased, Oct. 31, 2024
- Non-U.S. Social Housing Providers Ratings History: October 2024, Oct. 31, 2024
- Cyber Risk Brief: U.K. Public Sector Is Increasingly Under Threat, Oct. 24, 2024
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 18, 2024
- U.K. Social Housing Borrowing 2024: Borrowing capacity remains constrained, March 6, 2024
- European Housing Markets: Forecast Brightens Amid Ongoing Correction, Jan. 25, 2024
- Non-U.S. Social Housing Sector Outlook 2024: At A Turning Point?, Nov. 29 2023
- Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks, Oct. 23, 2023

Ratings List

Downgraded; Outlook Action

	To	From
Sovereign Housing Association Ltd.		
Issuer Credit Rating	A-/Stable/--	A/Negative/--
Senior Secured	A-	A

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.