S&P Global
Ratings

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Summary:

Sovereign Housing Association Ltd.

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Summary:

Sovereign Housing Association Ltd.

Issuer Credit Rating	A+/Negative/--

Key Rating Factors

Enterprise Profile

- Strong demand for affordable housing and shared-ownership housing in Sovereign Housing Association Ltd.'s (Sovereign's) areas of operation translates into an increasing development program over the next few years.
- We understand that Sovereign's exposure to market-related activities will remain controlled and constitute less than one-third of its total turnover over the fiscal year (FY) 2020-FY2022 forecast period. This level of exposure is one of the group's key policies.
- Sovereign's asset quality and operational performance remain very strong, supported by very low vacancy rates.

Financial Profile

- We anticipate that Sovereign's S&P Global Ratings-adjusted EBITDA margins will remain solid at just below 40% over the FY2020-FY2022 forecast period, albeit declining from previous years' levels due to a projected increase in repairs.
- Sovereign's debt will increase substantially throughout FY2022 as a result of an increasing development program, but we project that debt to EBITDA will remain moderate, below 15x, alongside very strong interest coverage above 2x.
- The group's liquidity position remains strong, thanks to additional facilities secured over the past 12 months to prepare for a ramp-up of the development plan.

Outlook

The negative outlook reflects our view that we would downgrade Sovereign if we were to lower our ratings on the U.K. Increased exposure to sales risk could also cause Sovereign's creditworthiness to weaken in the next 12 months, particularly in the context of a disruptive Brexit, which will cause the macroeconomic environment to deteriorate further and provoke a significant drop in house prices.

Downside scenario

As our rating on Sovereign benefits from a one-notch uplift as a result of government support, if we were to lower our ratings on the U.K., we would downgrade Sovereign. We could also lower the rating if Sovereign became heavily reliant on sales activities; for instance, if Sovereign's management breached the limit in its latest business plan of 35% of turnover from sales, including the group's share of joint-venture sales. This could erode Sovereign's ability to withstand market fluctuations by increasing its exposure to cyclical sales more than is typical for a traditional social housing rental business. Greater exposure to cyclical sales would increase the volatility of Sovereign's operating surplus and put pressure on its operating margins and liquidity.

Upside scenario

We could revise the outlook to stable in the next 12 months if we took a similar action on the U.K. sovereign ratings and if Sovereign proves able to maintain strong financials without increasing its exposure to market-related activities compared with our baseline scenario.

Rationale

Our rating on Sovereign is one notch higher than its 'a' stand-alone credit profile (SACP), based on our assessment of a moderately high likelihood that the U.K. government--working through the Regulator of Social Housing (RSH)--would provide timely and sufficient extraordinary support to the group in the event of financial distress.

We base this view on Sovereign's important role for the U.K. government due to its public policy mandate, and its strong link with the government. In our view, Sovereign, like other housing associations in England, plays an important role in providing housing and has a strong link with the RSH. This is demonstrated by the government's track record of providing robust credit support to the social housing sector in certain circumstances.

The rating also reflects our base-case expectation that Sovereign will continue posting robust profitability thanks to its large asset base of social housing units, with close to 58,000 homes under management since its merger with Spectrum Housing Group (Spectrum) in 2016. Further support will come from Sovereign's solid debt and interest coverage with revenues from its social housing activities over the next three years.

In order to address strong demand for affordable housing in the South of England, we anticipate that Sovereign will ramp up its development plan and deliver about 1,650 new homes per year on average (excluding development through joint ventures). This is more than the 1,500 new homes Sovereign completed in 2018-2019, which has already made Sovereign one of the largest social housing developers in the U.K. We also expect Sovereign to limit its exposure to sales activities to less than one-third of its revenues over the coming years. As a result, we still view Sovereign as a social housing provider that is exposed to low industry risk.

Our assessment of Sovereign's SACP reflects the group's strong enterprise profile, supported by its very strong asset quality and operational performance, as illustrated by the very low vacancy rate, which stood at just above 1% of net rental income over FY2019. We also expect Sovereign to control the negative impact of welfare reforms and the roll out of Universal Credit by keeping arrears below 6% of net rental income over the next few years. Nevertheless, our assessment of Sovereign's economic fundamentals remains constrained by its exposure to nontraditional activities, chiefly first-tranche sales of shared-ownership properties that we view as riskier than traditional lettings. We expect these sales to account for about 20% of Sovereign's total turnover throughout FY2022, a stable level compared to FY2019.

Despite changes at the top executive level over the past two years, we consider that Sovereign has maintained sufficient expertise to manage its significant development program, even faced with various reforms and Brexit. We also factor into our base case management's ability to limit sales activities to 35% of total turnover over the coming years, and to maintain solid profitability and control debt after the full consolidation of Spectrum following the merger three years ago.

Our rating on Sovereign is supported by our view that the group's financial profile will remain strong in our updated 2020-2022 base case. In FY2019, Sovereign posted a very solid adjusted EBITDA margin of 40%, fully in line with our last base case. Positively, Sovereign has completed its targeted savings a year earlier than it forecast following its merger with Spectrum.

Since our base case now anticipates higher levels of repairs, including fire safety measures, we project that Sovereign's adjusted EBITDA margins will gradually fall to below 40% over the next few years. We forecast that the profitability of lettings will remain sound, supported by the new rent regime to be implemented from 2021. Therefore, we expect Sovereign to absorb the additional debt it needs to finance the development plan and still maintain moderate leverage compared with peers at just 12x. This is higher than our former base-case projection, however, due to greater development plan commitments. Adjusted EBITDA interest coverage will continue to stand above 2x over our FY2018-FY2022 base-case period, and we anticipate that the coverage ratio, based on social housing lettings alone, will also remain higher than that of U.K. peers.

Liquidity

We continue to view Sovereign's liquidity position as strong. We expect the group's sources of liquidity to exceed planned uses by 1.5x over the next 12 months, fully in line with our last base case. The group has secured additional facilities over the past few months, including a £250 million unsecured revolving credit facility, in order to prepare for the ramp-up of its development plan.

Liquidity sources include:

- Available funds under undrawn committed facilities expiring beyond 12 months of £500 million;
- Cash flow from operations (before interest payments) of about £150 million;
- Cash of £23 million; and
- Proceeds from asset sales of about £13 million.

Liquidity uses include:

- Capital expenditure of about £300 million;
- Debt service (including interest costs) of about £120 million; and
- Other expenditure associated with IT and Sovereign's office strategy of about £16 million.

We view Sovereign's access to external liquidity as satisfactory, given its ready access to bank funding, but limited track record of issuance on the capital markets.

Key Statistics

Table 1

Sovereign Housing Association Ltd. Selected Financial Indicators					
	--Year ended March 31--				
(Mil. £)	**2018a**	**2019a**	**2020bc**	**2021bc**	**2022bc**
Number of units owned or managed	56649	57987	59679	61290	62812
Vacancy rates* (%)	1.3	1.1	N.A.	N.A.	N.A.
Arrears* (%)	3.6	3.4	N.A.	N.A.	N.A.
Revenue§	375.6	399.5	400.1	409.6	444.7
Share of revenue from nontraditional activities (%)	20	24	23	21	23
EBITDA§†	160.6	160.6	148.5	153.0	166.1
EBITDA/revenue§† (%)	42.8	40.2	37.1	37.4	37.4
Interest expense**	62.2	64.3	77.1	86.6	95.6
Debt/EBITDA§† (x)	9.9	10.6	13.1	13.9	14
EBITDA/interest coverage§†** (x)	2.6	2.5	1.9	1.8	1.7
Capital expense†	162.2	208.4	338.8	288.7	253.6
Debt	1595.2	1709	1948.1	2133.3	2325.2
Housing properties (according to balance sheet valuation)	3792.7	4002.2	N.A.	N.A.	N.A.
Loan to value of properties (%)	42.0	42.7	76.2	74.7	73
Cash and liquid assets	26.2	45.2	38.5	49.5	69.7

*Rent and service charge. §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

Sovereign Housing Association Ltd. Ratings Score Snapshot	
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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

- The State Of Social Housing: Is The English Model Catching On?, July 25, 2019
- United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019

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