Research Update:

U.K.-Based Sovereign Housing Association Ltd. Outlook Revised To Stable; 'A+' Rating Affirmed

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Overview

- We expect Sovereign Housing Association Ltd. will continue to benefit from strong demand for its properties and deliver its ambitious development plan while keeping strong liquidity and a moderate debt burden.
- A strategic shift to significantly increase investment in existing stock will support Sovereign's asset quality, but it will also put pressure on the group's profitability over the financial year ending March 31, 2021 (FY2021) to FY2023.
- We are affirming our 'A+' long-term issuer credit rating on Sovereign.
- The stable outlook reflects our view that management's strategy to invest in its asset base will support the business' long-term prospects.

Rating Action

On Oct. 28, 2020, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K. social housing provider Sovereign Housing Association Ltd. The outlook is stable.

We also affirmed our 'A+' issue rating on Sovereign Housing Capital PLC's £375 million, £250 million, and £175 million senior secured bonds. Sovereign Housing Capital is a special-purpose financing vehicle set up for the sole purpose of issuing bonds and lending the proceeds to Sovereign, and we view it as a core subsidiary of the Sovereign Housing Group.

Rationale

The ratings on Sovereign are stabilizing at the current level because risks associated with sales are receding. With a strategic shift of investment toward existing stock, we do not expect revenue from sales activities to approach one-third of total revenue. The group has significantly expanded the scope of its business plan from last year. It now incorporates significantly higher maintenance spending to improve the safety and condition of existing stock, targets a higher home and place standard to work toward achieving the 2050 zero carbon objective, and employs an asset management strategy to dispose of noncore units or rental units that do not fit in with the new home and place standard. The group expects it will spend £625 million to comply with its new home and place standard over the next 30 years. Over time, we think the group's homes will be well positioned to meet future consumer, environmental, and construction regulations, reducing both enterprise and financial risks in the longer term.

The 'A+' rating on Sovereign incorporates one notch of uplift from the 'a' stand-alone credit profile, reflecting our view that there is moderately high likelihood that the entity would receive extraordinary support in case of financial distress. Sovereign's primary purpose is to provide affordable homes, supporting important policy objectives of the U.K. government. We note that the Regulator of Social Housing (RSH), a government agency, regulates Sovereign to promote a viable, efficient, and well-governed social-housing sector, as well as to maintain lender confidence and low funding costs across the sector. We therefore think the RSH would step in to prevent a default in the sector, based on its track record of being willing and able to provide extraordinary support on a timely basis.

Sovereign's very strong asset quality and operational performance support its strong enterprise profile, as demonstrated by the very low arrears and vacancy rate, which stood at just above 1% of total rent and service charges receivable for FY2020. However, the COVID-19 pandemic could affect rent collection, since about 45% of Sovereign's tenants are self-funders and do not receive housing benefits, increasing the group's exposure to the labor market and the generosity of the government's support schemes. Nevertheless, we still expect Sovereign's gross arrears to remain very moderate compared with peers' because the group started the pandemic in a very strong position, with gross arrears standing at less than 4% of total rent and service charge receivable for FY2020.

We anticipate that Sovereign will remain consistent with its previous development ambitions and aim to develop 1,900 mixed tenure homes per year from FY2022, which will support performance and address strong demand for affordable housing in the South of England. As a result of pandemic-related delays in production and completions this year, the group only expects to complete about 1,000 homes in FY2021. We expect developments for sale will account for about 40% of the total development plan during FY2021-FY2023, but that exposure to sales activities will remain below one-third of revenue over the coming years, which limits the volatility that this revenue introduces in the business.

Despite changes at the top executive level over the past two years, we consider that Sovereign's management has the expertise to manage its significant development program. We factor into our base case management's ability to deliver its increased investment program while maintaining solid profitability and moderate debt.

We anticipate higher maintenance expenditure, including fire safety work, will affect profitability, but that adjusted EBITDA margins will remain solid at 33% on average over FY2021-FY2023. A key focus of this maintenance expenditure will be working toward achieving an EPC C rating for all Sovereign's stock by 2035. An increasing share of low margin development for sale activities will put additional pressure on this metric. That said, the supportive consumer price index +1% rent settlement for social and affordable lettings, along with the group's development efforts, will counterbalance this pressure. We expect adjusted EBITDA margins will remain structurally above 30% over the forecast period.

Despite weakening profitability, increased fixed asset sale receipts over the forecast period will enable the group to deliver its capital and investment program without a significant recourse to debt. We expect £300 million of cash receipts from disposals from FY2021-FY2023 will allow the group to keep its debt burden moderate. We forecast debt to adjusted EBITDA to average a healthy 14.8x over the forecast period, which is relatively low compared to peers with similar development programs but higher compared to historical levels. Sovereign's interest cover ratio is also relatively strong compared to peers', averaging 2x throughout our base case, supported by Sovereign's recent debt issuances with low interest rates. We expect income from nonsale traditional activities will continue to comfortably cover interest costs through 2023 (by 1.6x on average over FY2021-FY2023).

Environmental, social, and governance (ESG) factors relevant to the rating action are:

- Health and safety
- Greenhouse gas emission factors

Liquidity

We think Sovereign's liquidity position has improved from last year. We now view Sovereign's liquidity as very strong, supported by the group's large undrawn but committed facilities. We expect sources of liquidity for the group to exceed planned uses by 2.2x over the next 12 months.

Liquidity sources include:

- Forecasted cash generated from continuing operation: £189 million;
- Cash and liquid investments: £86 million;
- Proceeds from asset sales: £66 million; and
- Undrawn, available portion of committed bank facilities or bank lines maturing beyond the next 12 months and can be drawn: £567 million.

Liquidity uses include:

- Expected capital expenditure: £304 million; and
- All interest and principal payable on short- and long-term debt obligations coming due: £104 million.

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

Outlook

The stable outlook reflects our view that management's strategy to invest in its asset base will support the business' long-term prospects.

Downside scenario

We could lower the rating should Sovereign's investments put greater pressure on the group's profitability than we currently expect, with adjusted EBITDA margins dropping structurally below 30%. We could also lower the rating if Sovereign were to fund consistent high capital expenditure with additional borrowing should it dispose of fewer assets than currently forecasted. We could also lower the rating if we thought the likelihood of timely extraordinary support to Sovereign from the U.K. government had decreased.

Upside scenario

We could raise the ratings on Sovereign if management built a strong track record of forward-looking decision making and materially improved the group's financial indicators from our current forecast.

Key Statistics

Table 1

Sovereign Housing Association Ltd. Key Statistics

	--Year ended March 31--				
(Mil. £)	**2019a**	**2020a**	**2021bc**	**2022bc**	**2023bc**
Number of units owned or managed	57,742	59,517	60,391	61,185	61,143
Revenue§	399.5	408.6	374.1	417.7	469.3
Share of revenue from sales activities (%)	18.7	20.3	11.7	16.3	23.0
EBITDA*§	160.6	139.4	134.1	135.8	146.9
EBITDA/revenue*§(%)	40.2	34.1	35.9	32.5	31.3
Capital expense§	208.4	267.7	251.3	331.2	351.7
Debt	1709.0	1897.1	1990.6	2100.0	2063.8
Debt/EBITDA*§(x)	10.6	13.6	14.8	15.5	14.0
Interest expense†	64.3	68.6	74.1	77.5	78.1
EBITDA/interest coverage*§† (x)	2.5	2.0	1.8	1.8	1.9
Cash and liquid assets	45.2	72.2	57.1	61.6	55.6

*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.

Ratings Score Snapshot

Table 2

Sovereign Housing Association Ltd. Ratings Score Snapshot

Industry risk	2
Economic fundamentals and market dependencies	4
Strategy and management	2
Asset quality and operational performance	1
Enterprise profile	3
Financial performance	4
Debt profile	3
Liquidity	2
Financial policies	2

Table 2

Sovereign Housing Association Ltd. Ratings Score Snapshot (cont.)

Financial profile	3

S&P Global Ratings bases its ratings on nonprofit 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 revenue from open market sales, we also refer to the "Key Credit Factors For The Homebuilder And Real Estate Developer Industry."

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- ESG Industry Report Card: Public And Nonprofit Social Housing Providers Outside The U.S., Aug. 4, 2020
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Global Social Housing Ratings Score Snapshot: December 2019, Dec. 2, 2019
- Global Social Housing Risk Indicators: December 2019, Dec. 2, 2019

Ratings List

Outlook Action/Ratings Affirmed;

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

Ratings Affirmed

Sovereign Housing Capital PLC	
Senior Secured	A+