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Ratings

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Research Update:

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

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Overview

- We project that Sovereign Housing Association Ltd. (Sovereign) will increase investments in its existing stock such that the group's S&P Global Ratings-adjusted EBITDA will decrease more than we previously assumed.
- Together with inflationary pressures on its cost base, which rent increases would likely not fully offset, we forecast that the group's adjusted EBITDA margins and nonsales EBITDA debt metrics will weaken.
- We revised the outlook on Sovereign to negative from stable and affirmed our 'A+' rating on the group.
- The negative outlook on Sovereign reflects the outlook on the U.K.

Rating Action

On Oct. 24, 2022, S&P Global Ratings revised its outlook on Sovereign to negative from stable. At the same time, we affirmed our 'A+' long-term issuer credit rating on the group.

We also affirmed our 'A+' issue rating on Sovereign Housing Capital PLC's senior secured bonds. Sovereign Housing Capital is a special-purpose finance 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 Sovereign.

Outlook

The negative outlook reflects the outlook on the U.K.

Downside scenario

We could lower the rating in the next two years if we were to lower our sovereign credit rating on the U.K. or if we revised downward our view of the likelihood of extraordinary support to Sovereign from the U.K. government in the event of financial distress.

We could also lower the rating if the group committed to a substantially larger maintenance and development program amid slow revenue increase, or if it materially increased its exposure to market sales.

Upside scenario

We could revise the outlook to stable if we revised the outlook on the U.K. to stable, while Sovereign performed largely in line with our base-case expectations. We could also revise the outlook to stable if the group's adjusted EBITDA increased beyond our expectations, supporting stronger financial metrics--specifically, adjusted nonsales EBITDA interest cover exceeding 1.25x, and debt to nonsales EBITDA improving to less than 20x, on a sustained basis, all else equal.

Rationale

The outlook revision reflects our view of Sovereign's weaker intrinsic credit quality and the negative outlook on the U.K. (see "United Kingdom Outlook Revised To Negative On Rising Fiscal Risks; 'AA/A-1+' Ratings Affirmed," published Sept. 30, 2022.

We assess that Sovereign's intrinsic credit quality has weakened because higher-than-previously-assumed investments into the group's existing homes will bring down the group's adjusted EBITDA. Sovereign will also face inflationary cost pressures that rent increases will not fully offset. As a result, we have revised downward the stand-alone credit profile (SACP) to 'a' from 'a+'

We think there is a moderately high likelihood that Sovereign would receive timely extraordinary government support in case of financial distress. Since one of the Regulator of Social Housing's (RSH) key goals is to maintain lender confidence and low funding costs across the sector, we think it is likely that the RSH would step in to 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 Sovereign. Therefore, we currently apply one notch of uplift from the SACP. If we were to lower our rating on the U.K. by one notch, we would no longer factor any notches of uplift into the rating on Sovereign.

We assume Sovereign's sales risk will be contained at less than one-third of the group's turnover, supported by the group's consistent strategy and solid risk management. Sovereign also continues to employ an asset management strategy to dispose of noncore units and dispose of and replace rental units that do not fit in with the new home and place standard. We assume that larger bulk sales of non-core assets, albeit delayed, will occur over the coming 12-24 months to streamline the group's activities with a focus on affordable rent and home ownership.

We assess the management team as very experienced, with solid background in the social housing sector. We consider management to have built-in flexibility in the planning process, as demonstrated by the group's capacity to scale back or pause development in recent years. We also view positively that Sovereign was one of the first social housing providers to generate a business plan incorporating the decarbonization goals, reflecting the group's long-term planning process compared to peers, supported by very comprehensive stress testing.

We think the demand for Sovereign's properties will remain solid because its social and affordable rent levels are low, at just below 60% on average of the prevailing market rent in the regions in which it operates across the south and southwest of England. This is further demonstrated, in our view, by Sovereign's vacancy rates. Voids were 1.1% of rent revenue in the fiscal year ending March 31, 2020 (fiscal 2020), rising to 1.7% over the past two years due to difficulties in reletting homes for the elderly during the pandemic and because of maintenance work being completed on other types of homes due for sale. Overall, we consider that Sovereign's void rates are in line with the rest of the English social housing sector.

We project that the group's adjusted EBITDA margins will drop below a modest 25% over the next three years, compared with an average of 35% over the past three years. Although we assume the group would fund part of its investment in existing and new homes with proceeds from fixed asset sales and grant funding, we think Sovereign would need to fund some of the development spend with debt. We therefore forecast that its adjusted non-sales EBITDA interest will fall below a still sound 1.5x, with debt to nonsales adjusted EBITDA exceeding a high 20x on a sustained basis, from fiscal 2023.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (for more information, see "Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers," published June 8, 2021).

Liquidity

We consider Sovereign's liquidity position to be very strong, based on a liquidity ratio of 1.8x and our view that Sovereign has satisfactory access to external liquidity.

Liquidity sources include:

- Forecasted cash generated from continuing operations, adding back noncash cost of sales, exceeding £170 million;
- Cash and liquidity investments of more than £35 million;
- Undrawn and available committed bank facilities or bank lines maturing beyond the next 12 months totaling £390 million;
- Proceeds from asset sales, incorporating bulk sales of existing homes; and
- Grant funding and other income exceeding £50 million.

Liquidity uses include:

- Expected capital expenditure, including development spend on units for sale of close to £450 million; and
- Interest and maturing debt repayments of more than £110 million.

Key Statistics

Table 1

Sovereign Housing Association Ltd.--Key Statistics

	--Year ended March 31--				
Mil. £	**2021a**	**2022e**	**2023bc**	**2024bc**	**2025bc**
Number of units owned or managed	60,641	61,310	59,898	60,200	61,310
Adjusted operating revenue	414.7	419.9	425.1	478.7	501.1

Table 1

Sovereign Housing Association Ltd.--Key Statistics (cont.)

	--Year ended March 31--				
Mil. £	**2021a**	**2022e**	**2023bc**	**2024bc**	**2025bc**
Adjusted EBITDA	157.0	135.7	99.5	109.9	115.1
Non-sales adjusted EBITDA	146.1	124.0	91.8	99.3	105.5
Capital expense	180.6	253.5	386.1	503.3	549.9
Debt	1918.4	2047.5	2030.4	2181.6	2464.4
Interest expense	69.9	69.3	75.0	78.7	90.2
Adjusted EBITDA/Adjusted operating revenue (%)	37.9	32.3	23.4	23.0	23.0
Debt/Non-sales adjusted EBITDA (x)	13.1	16.5	22.1	22.0	23.4
Non-sales adjusted EBITDA/interest coverage(x)	2.1	1.8	1.2	1.3	1.2

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

Ratings Score Snapshot

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 seven main rating factors listed in the table above. S&P Global Ratings' "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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 2022
- United Kingdom Outlook Revised To Negative On Rising Fiscal Risks; 'AA/A-1+' Ratings Affirmed, Sept. 30, 2022
- Bulletin: Launch Of Rent Cap Consultation Adds Uncertainty To Creditworthiness Across English Housing Sector, Sept. 1, 2022
- Rated U.K. Social Housing Providers' Creditworthiness Could Suffer If The Gap Between Rent And Cost Increases Persists, Aug. 1, 2022
- Non-U.S. Social Housing Providers Ratings Score Snapshot: July 2022, July 27, 2022
- Non-U.S. Social Housing Providers Ratings Risk Indicators: July 2022, July 27, 2022
- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers, June 8, 2021
- Building Up Debt: U.K. Social Housing Sector Braces Itself For Borrowing, March 16, 2021
- Outlook 2021: Strong Liquidity Should Help Social Housing Providers Remain Resilient, Dec. 8, 2020
- ESG Industry Report Card: Public And Nonprofit Social Housing Providers Outside The U.S., Aug. 4, 2020

Ratings List

Ratings Affirmed		
Sovereign Housing Capital PLC		
Senior Secured	A+	
Ratings Affirmed; Outlook Action		
	To	**From**
Sovereign Housing Association Ltd.		
Issuer Credit Rating	A+/Negative/--	A+/Stable/--

box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914