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CREDIT OPINION
27 October 2023

Update

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RATINGS

Sovereign Housing Association

Domicile	London, United Kingdom
Long Term Rating	A3
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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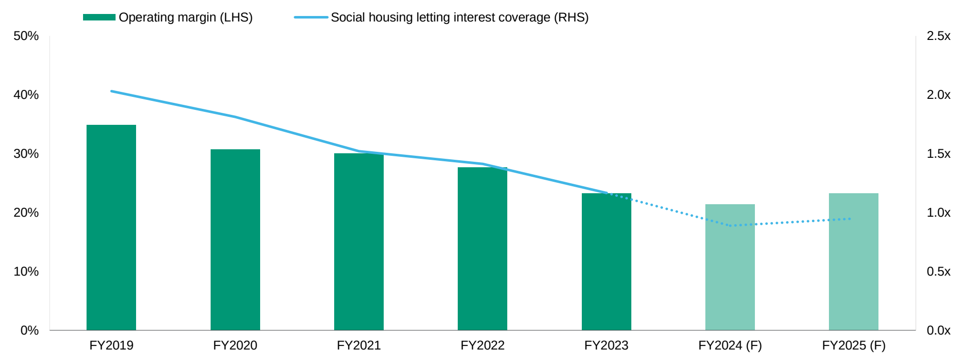
Sovereign Housing Association (UK)

Update following outlook change to stable from negative

Summary

The credit profile of Sovereign Housing Association (Sovereign, A3 stable) reflects its large size, solid operating margins and good financial management. The rating also considers Sovereign's high leverage, large development programme and its recent merger with Network Homes (now Sovereign Network Homes), which has weaker financial performance. Sovereign benefits from the supportive regulatory framework governing English housing associations (HAs) and a strong likelihood that the government of the United Kingdom (Aa3 stable) would intervene in the event that Sovereign faced acute liquidity stress.

Exhibit 1
Sovereign's interest coverage and operating performance will weaken as a result of the merger and increased spending on existing units
Operating margin and social housing letting interest coverage



Fiscal years 2024 and 2025 are post-merger forecasts based on the combined FFRs of Sovereign and Sovereign Network Homes
Source: Sovereign Housing Association, Moody's Investors Service

Credit strengths

» Large organisation with good operating performance

» Solid interest coverage, but expected to decline

» Supportive institutional framework in England

Credit challenges

» Substantial development and market sales risk

» High debt to revenues, but expected to remain relatively stable

Rating outlook

The stable outlook reflects the expected gradual reduction in inflation and associated cost pressures as well as the proactive actions taken by the issuer to mitigate the adverse effects of the weaker operating environment, thereby limiting development risk.

Factors that could lead to an upgrade

Upward pressure on the ratings could result from a significant improvement in operating performance, a material reduction in debt or a significant increase in government support for the sector.

Factors that could lead to a downgrade

Downward pressure on the ratings could result from a prolonged weakening in operating performance, debt growing more quickly than forecasts, weaker liquidity or a failure to adapt strategies and risk appetite to mitigate weaker economic conditions. Lower government support for the sector or a dilution of the regulatory framework could also lead to downward pressure on the ratings.

Key indicators

Exhibit 2

Sovereign Housing Association	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23	31-Mar-24 (F)	31-Mar-25 (F)
Units under management (no.)	57,742	59,517	60,355	61,023	62,026	82,910	84,572
Operating margin, before interest (%)	34.9	30.8	30.1	27.7	23.3	21.4	23.2
Net capital expenditure as % turnover	29.1	45.1	14.3	47.2	52.6	74.0	73.6
Social housing letting interest coverage (x times)	2.0	1.8	1.5	1.4	1.2	0.9	0.9
Cash flow volatility interest coverage (x times)	2.7	1.6	2.0	1.8	2.4	1.2	1.4
Debt to revenues (x times)	4.3	4.6	4.6	4.8	5.0	5.0	4.9
Debt to assets at cost (%)	49.9	50.4	49.3	49.3	49.5	52.0	51.8

Fiscal years 2024 and 2025 are post-merger forecasts based on the combined FFRs of Sovereign and Sovereign Network Homes (formerly Network Homes)
Source: Sovereign Housing Association, Moody's Investors Service

Detailed credit considerations

On 25 October 2023, Moody's changed the outlook to stable from negative and affirmed Sovereign's baa2 BCA and A3 issuer ratings. The change in outlook followed Moody's change in outlook of the Government of the United Kingdom's Aa3 rating to stable from negative on 20 October 2023.

Sovereign's A3 ratings combines: (1) its Baseline Credit Assessment (BCA) of baa2, and (2) a strong likelihood of extraordinary support from the UK government in the event that Sovereign faced acute liquidity stress.

Baseline credit assessment

Large organisation with good operating performance

Sovereign is a large regional housing association concentrated in the South of England with over 62,000 units owned and managed as of the end of fiscal 2023. As of 2nd October, Sovereign has merged with Network Homes (now Sovereign Network Homes), a large London-based housing association with around 21,000 units, with Sovereign Network and its subsidiaries becoming subsidiaries of Sovereign Housing Association. As a result Sovereign now has over 82,000 units which puts it in the top 10 housing associations in England by size. In our view, larger HAs have more political influence, particularly as Sovereign will now be a member of the G15 (an industry body of the largest housing associations in and around London), due to Sovereign Network's existing membership.

While Sovereign's operating performance has weakened since fiscal 2021 - falling from 30% to 23% by fiscal 2023, it remains more or less aligned with the A3 rated peer median. Operating margins in the sector have fallen due to high cost inflation, a significant backlog of mostly expensed (rather than capitalised) repairs and maintenance built up during the pandemic, and - in fiscal 2023 - a sub-inflationary rent cap imposed by the UK government. Sovereign Network has the additional challenge of significant expenditure on fire safety due to its ownership of a large number of high-rises, contributing to weak margins of just 17% and 12% in fiscal 2022 and 2023 respectively. However, unlike some other large HAs, Sovereign has been able to maintain strong sales margins over recent history - with an average of 18% achieved over the past three years. Sovereign's development assumptions continue to be conservative and include some potential for upside.

The merged organisation expects to improve margins as inflation unwinds and rents catch-up. However, due to the lack of geographical crossover between Sovereign and Sovereign Network's housing stock, efficiencies not expected to be realised over the medium term, and instead integration costs will be incurred, particularly on technological integration.

Solid interest coverage, but expected to decline

Sovereign's social housing lettings interest coverage (SHLIC) has declined, in line with its operating margin, in recent years, dropping from 1.5x in fiscal 2021 to 1.2x in fiscal 2023, for similar reasons to that of its margin. It remains marginally above the A3 rated peer median of 1.1x. We expect SHLIC to decline, partly due to its merger with Sovereign Network which has a weaker track record of just 0.9x in fiscal 2022 and 0.6x in fiscal 2023, and also due to the general sector pressures described above. Sovereign's SHLIC is likely to be around 0.9-1.0x over the next few years as mandatory expenditure pressures continue, particularly on fire/building safety costs as well as decarbonisation.

Capitalised major repairs, including decarbonisation costs and fire and building safety, are expected to be around £520 million over the next five years, and - as a result - Sovereign and Sovereign Network have renegotiated their EBITDA interest cover covenants to remove the MRI (major repairs included) element giving substantially higher headroom, of around 80 basis points on its tightest covenant as at fiscal year end 2024.

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong institutional framework governing English housing associations (HAs) reflected in an Operating Environment score of a3 and a Regulatory Framework score of a1. These scores are assigned at a national level and reflect the following credit considerations:

The regulator maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and by undertaking biennial In-Depth Assessments (IDAs) for large and complex HAs. The regulator has a strong track record of intervention in cases of mismanagement or financial stress with powers to provide financial assistance and/or make manager appointments where there has been a breach of regulatory standards.

The operating environment for English HAs remains supportive. Demand for social housing remains very high and the government has committed to increased capital grant on more flexible terms for new social housing. English HAs retain some expenditure flexibility and have a track record of reducing costs to mitigate lower income.

However, due to presently very high rates of inflation, the government has intervened on social rent policy with a 7% ceiling on social rent increases implemented in fiscal 2024. The ceiling of 7% results in an adverse differential between rental income and cost growth, driving lower margins and interest coverage. The intervention introduces policy volatility to the sector as the ceiling will supersede the allowable increase of consumer price inflation (CPI) plus 1% under the current rent standard, which is in place until March 2025.

Substantial development and market sales risk

Sovereign has a large development programme with an ambition for the merged organisation to deliver around 2,500 units per year over the next five years, with around 50% general needs/affordable rent, 34% shared ownership and the remainder outright sales. The majority of the outright sales development will be undertaken through joint ventures (JVs) with homebuilder partners, sharing risk. Its appetite for market sales risk is high for the sector - with a golden rule of a maximum of 40% of turnover from these tenures. It forecasts market sales (including first tranche shared ownership) to represent around 26% of turnover over the next three years.

Its large development programme and other capital expenditure commitments is reflected in its high net capital expenditure levels of 69% on average to fiscal 2026, compared with the average peer median of 31% over the same period.

We expect that Sovereign will continue to effectively manage its develop programme, although weaker economic and financial conditions will present a continual challenge to be managed. Sovereign performs extensive stress testing and sensitivity analysis and has identified a number of risk mitigating actions it could implement if adverse conditions prevail.

High debt to revenues but expected to remain relatively stable due to disposals programme

Sovereign's debt burden is above the median of its rated peers, primarily due to its large-scale voluntary transfer history. As of fiscal year end 2023 its debt to revenue metric was at 5.0x, compared with the 4.4x A3 peer median. However, gearing is more in line with the A3 median at 50%. Sovereign's debt metrics are expected to stay relatively stable, as assets and revenues increase in line with debt levels - with debt expected to increase from around £4.9 billion (at FYE 2024 post-merger) to £6 billion by fiscal year end 2028. Sovereign intends to keep its debt metrics relatively stable through funding around a third of its development programme through disposals of non-core fixed assets.

Its liquidity coverage is expected to remain decent - with financing plans in the remainder of fiscal 2024 to achieve continued compliance with its liquidity policy of keeping 23 months of net capital expenditure in cash and immediately available facilities.

Sovereign's unencumbered asset position, a measure of its long-term borrowing capacity, is strong, with an estimated value of £2.0 billion at EUV-SH (Existing Use Value for Social Housing) as of October 2023. Unencumbered assets will erode as Sovereign increases borrowing but will remain solid.

Extraordinary support considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers available to the regulator in cases of financial distress, with the possibility of a facilitated merger or a transfer of engagements. However, the process can be protracted and is reliant on HAs agreeing to merge, which could be more challenging in a weakening operating environment. Recent history has shown that the UK government is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support assumption also factors increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more challenging. In addition, our assessment that there is a very high default dependence between Sovereign and the UK government reflects their strong financial and operational linkages.

ESG Considerations

Sovereign Housing Association's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 3

ESG Credit Impact Score

CIS-3

Moderately Negative

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.

Source: Moody's Investors Service

Sovereign's CIS (**CIS-3**) reflects our view that ESG risks in their totality have a materially negative impact on its rating. In particular the expenditure requirements related to the carbon transition and building safety which will weaken margins and increase financing needs, as well as affordability constraints for low-income tenants which have led to government-imposed rent caps in the sector.

Exhibit 4
ESG Issuer Profile Scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-3	S-4	G-2
Moderately Negative	Highly Negative	Neutral-to-Low

Source: Moody's Investors Service

Environmental

Sovereign's exposure to environmental risks (**E-3**) relates to its material exposure to carbon transition risks as a relatively high proportion of its stock requires retrofit to meet EPC-C standards by 2035. This will increase capital expenditure over this time period, although Sovereign will partially offset the impact on debt through reduced development activity.

Social

Sovereign's exposure to social risks (**S-4**) reflects the impact of responsible production policies and demographic and societal trends. Responsible production risks include the legislative requirement to improve the safety of its existing housing stock which will increase expenditure over the medium term. Its exposure to demographic and societal trends risks reflects the vulnerability of the sector to tenant affordability and the subsequent impact of the government's actions to preserve affordability through its rent setting powers. The government's recent intervention on rent setting through setting a sub-inflationary rent cap on the sector has weakened financial performance.The government's recent intervention on social rent policy with a ceiling on social rent increases introduces policy volatility to the sector and will have a negative impact on financial performance.

Governance

Sovereign's governance is robust with clearly identified policies and golden rules shaping its management of risk. Management and the Board are responsive to adverse events, although development risk remains high for the sector albeit well-managed.

Rating methodology and scorecard factors

The assigned BCA of baa2 is the same as the scorecard-indicated BCA outcome.

The methodologies used in this rating were the European Social Housing Providers rating methodology, published in April 2018, and the Government-Related Issuers rating methodology, published in February 2020.

Exhibit 5

Sovereign's fiscal 2023 scorecard

Sovereign Housing Association			
Baseline Credit Assessment	Sub-factor Weighting	Value	Score
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	62,026	aa
Factor 3: Financial Performance			
Operating Margin	5%	23.3%	baa
Social Housing Letting Interest Coverage	10%	1.2x	baa
Cash-Flow Volatility Interest Coverage	10%	2.4x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	5.0x	ba
Debt to Assets	10%	49.5%	ba
Liquidity Coverage	10%	0.3x	ba
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Scorecard - Indicated BCA Outcome			**baa2**
Assigned BCA			**baa2**

Source: Moody's Investors Service, Sovereign Housing Association

Ratings

Exhibit 6

Category	Moody's Rating
SOVEREIGN HOUSING ASSOCIATION	
Outlook	Stable
Baseline Credit Assessment	baa2
Issuer Rating	A3
SOVEREIGN HOUSING CAPITAL, PLC	
Outlook	Stable
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

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