MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
4 December 2020

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RATINGS

Sovereign Housing Association

Domicile	London, United Kingdom
Long Term Rating	A2
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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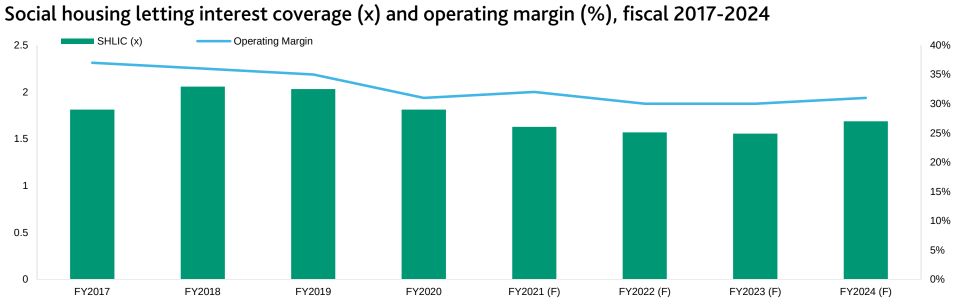
Sovereign Housing Association

Update to credit analysis

Summary

The credit profile of Sovereign Housing Association (A2 stable) reflects its large size, strong operating margin and stable cash flows supporting solid interest cover ratios. The rating also considers Sovereign's moderately higher debt level and increasing development and market sales risk. In addition, the sector benefits from the strong 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 strong operating stability and performance is expected to continue
Social housing letting interest coverage (x) and operating margin (%), fiscal 2017-2024



FY2017-20 are audited financial statements, FY2021-24 are based on business plan figures
Source: Moody's Investors Service, Sovereign Housing Association

Credit strengths

» Large regional housing association with strong profitability

» Steady cash flows, asset management support strong interest cover ratios

» Supportive institutional framework in England

Credit challenges

» Rising development and market sales risk

» Weakening debt metrics due to increased borrowing to fund development

Rating outlook

The stable outlook on Sovereign's rating reflects our view that its growing development and market sales risk is balanced by its strong profitability. It also reflects the stable operating environment for housing associations.

Factors that could lead to an upgrade

Upward pressure on Sovereign's rating could result from improved debt ratios including gearing sustained below 40% and debt to revenues below 3.5x, as well as improved liquidity coverage sustained above 1.5x.

Factors that could lead to a downgrade

Downward pressure on Sovereign's rating could result from a material scaling up of its development programme, leading to increased debt or a deterioration in its liquidity coverage ratio; a weakening in the social housing lettings interest cover (SHLIC) to levels below 1.5x on a sustained basis; or a failure to adapt strategies and risk appetite to mitigate against weaker economic conditions and operating performance. Moreover, a dilution of regulatory oversight or government support for the sector could also exert downward pressure on Sovereign's rating.

Key indicators

Exhibit 2

Sovereign Housing Association

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21(F)	31-Mar-22 (F)
Units under management (no.)	36,620	56,235	56,390	57,742	59,517	60,362	60,953
Operating margin, before interest (%)	35.1	36.6	36.3	34.9	30.8	31.6	30.4
Net capital expenditure as % turnover	24.8	33.0	17.8	29.1	45.1	42.5	51.6
Social housing letting interest coverage (x times)	1.8	1.8	2.1	2.0	1.8	1.6	1.6
Cash flow volatility interest coverage (x times)	2.3	2.0	2.3	2.7	1.6	1.6	1.9
Debt to revenues (x times)	5.0	4.3	4.2	4.3	4.6	5.1	4.9
Debt to assets at cost (%)	53.7	52.0	49.5	49.9	50.4	51.3	51.4

Source: Sovereign Housing Association, Moody's Investors Service

Detailed credit considerations

Sovereign's rating combines (1) its Baseline Credit Assessment (BCA) of a3, 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 regional housing association with strong profitability

Sovereign is a strong regional housing association concentrated in the South of England with nearly 60,000 units owned and managed as of the end of fiscal 2020. While centred around South East England, the group has sought opportunities to expand around its current footprint from its existing geographical area.

Sovereign's operating margin of 31% in fiscal 2020 was above the A2-rated peer median of 28% (fiscal 2020). The strong profitability was driven by high margins on its social housing lettings, for which the group reported a margin of 35% in fiscal 2020 compared to 19% on its market sales for the year. According to its 2020 business plan, Sovereign's operating margin is expected to remain stable, and moderately stronger relative to that of its peers, averaging 31% over the next three years. Whilst Sovereign's exposure to market sales as a percentage of turnover is expected to rise to 30% in fiscal 2025 from 20% in fiscal 2020, the lower profitability from this revenue source will be offset by strong margins on social housing lettings. Social housing lettings margin is expected to strengthen to 38% in fiscal 2025, up from 35% in fiscal 2020, underscoring the profitability of the core social housing business.

Steady cash flows, asset management support strong interest cover ratios

Sovereign's strong operating performance supports its stable cash flows and solid interest cover ratios. The strong projected performance in margins is expected to be supported by efficiency savings scaling up from fiscal 2022 onwards to target £18 million by fiscal 2024. Sovereign also plans to achieve asset disposals through its Strategic Asset Management (SAM) strategy, further supporting its cash flows and interest cover ratios.

Sovereign is planning to take a more active approach to its asset management, developing a strategy to dispose of noncore stock to invest in and improve existing stock, while also selling less efficient core rental properties to invest in new rental stock. It aims to replace 450 units, around 1%, of such core rental units per annum from fiscal 2024 onwards. These investments will help improve the condition of its asset base over time to meet its new Home and Place Standard, which it is in the process of setting and approving. Moreover, Sovereign has a goal of achieving zero carbon by 2050, which is in line with the UK government target.

Despite its growing market sales programme, Sovereign's operating cash flow is expected to remain relatively stable. Its cash flow volatility interest cover (CVIC) weakened in fiscal 2020 to 1.6x from 2.7x in fiscal 2019, driven by investment in existing stock and digital technology, part of Sovereign's strategy to improve customer service delivery. However, CVIC is expected to recover to its historic levels, strengthening to 2.5x by fiscal 2025 as disposals from the SAM programme and market sales increase operating cash flows.

Sovereign's social housing lettings interest cover (SHLIC), which measures the cover of cash interest payments from social housing letting surplus, was 1.8x in fiscal 2020, stronger than the A2-rated peer median of 1.4x (fiscal 2020). However, as the association plans to focus more on nonsocial housing letting activities and take on additional debt, its SHLIC is expected to weaken modestly in the near-term, averaging 1.6x over the next three years. Despite this, Sovereign's SHLIC still remains stronger than rated peers, supported by its profitable social housing lettings business.

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong regulatory framework governing English HAs. 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. In response to the coronavirus pandemic, the regulator adapted some aspects of its oversight temporarily, for example, extending its liquidity monitoring, briefly pausing the programme of IDAs and delaying regulatory submissions to reduce the operational burden on 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 has improved under more supportive policies for social rent increases and capital grant. Following four years of social rent reductions, HAs now benefit from a return to inflation-linked rent increases from April 2020 for five years. In addition, the government has committed to increased capital grant on more flexible terms for new social housing.

Counterbalancing the improvements, we expect policy to drive increased borrowing and development risk in the sector as it responds to the government's objective to deliver a significant increase in the construction of new homes.

Rising development and market sales risk

Sovereign remains committed to growth with an aim to increase its annual output of new homes to around 1,900 from around 1,200 in 2017. Due to the effects of the COVID-19 pandemic, which delayed construction and completions, Sovereign will miss its previously-planned target or delivering 1,900 homes in fiscal 2021. Nevertheless, the housing association aims to achieve the 1,900 target in fiscal 2022. The increase in development spending and risk is captured in the net capital expenditure (capex) to revenues ratio, averaging 46% over the next four years, before increasing to 63% in FY2025.

The development programme incorporates several tenures including social and affordable rent, shared ownership and outright sales (both through Sovereign and through joint ventures). New units coming online, in addition to the return to inflation-linked rents, will support steady revenue growth, averaging 5.5% per year over the next three years, reaching £483 million by fiscal 2023, up from £411 million in fiscal 2020.

Over the last year, the group has modified its development strategy in a few areas, signalling a greater openness to risk for higher growth in but greater control over development. Sovereign purchased the Clifton Down shopping centre in October 2020 as part of its medium to long-term development plan, underscoring its shift to a more land-led development approach. Sovereign has a target of 50% land-led development by fiscal 2025, which will give it more control over sites and tenures. Sovereign exited one underperforming joint venture (JV) with minimal cost to the group over the year, but plans to develop approximately 6% of its development programme through JVs over the next five years. Its development plans post fiscal 2024 incorporate plans to increase development to over 2,600 a year through additional regeneration projects.

Sovereign's exposure to market sales will continue to grow modestly in the next five years, as the HA develops its shared ownership and open market sales units. However, total sales as a percentage of turnover is expected to temporarily dip to 12% in FY2021, down from 20% in FY2020, due to the impact of the coronavirus driving lower sales volumes. This metric is set to increase year-on-year, rising to 30% by FY2024 as Sovereign completes units and sales volumes pick up.

Although there have been recent changes to its senior management team, we expect Sovereign will continue to effectively manage its increased development programme. While the business plan incorporates an increase in market sales activity, Sovereign's financial standards limit the amount of exposure, although the tolerance increased in the past two years to a limit of 35% total sales as a percentage of revenues, from 30% previously. Exposure is expected to remain comfortably below this limit until FY2024, after which Sovereign will be close to this level. However, Sovereign has flexibility in its development programme. Only a quarter of its planned development over the next four years is committed. Additionally, Sovereign performs extensive stress testing and has demonstrated timely response to events, such as through its increased liquidity and mitigating actions taken in response to the effects of the pandemic.

Weakening debt metrics due to increased borrowing to fund development

Sovereign's debt burden is above the median of its rated peers, primarily due to its large-scale voluntary transfer history. Over the next three years, the group's debt ratios will weaken due to accelerated debt growth to fund its increased development output.

As of fiscal 2020, Sovereign's debt (net of cash) of £1.8 billion was equivalent to 4.6x revenue and 50% of assets at cost (gearing), compared with the A2-rated peer medians of 3.9x and 47%, respectively. Debt will increase, reaching £2.2 billion by fiscal 2025, which will negatively impact debt ratios. Debt to revenues will rise to 5.1x by fiscal 2021 and gearing will increase to 51% by fiscal 2022. However, we expect that debt ratios will decline from these peaks as Sovereign increases its revenue and adds to its stock, being favourable compared to current ratios by FY2025.

Management uses standalone interest rate swaps for hedging (notional amount of £316 million), including some inflation and LIBOR linked swaps, which introduces the risk of margin calls and consequent collateral posting. As of August 2020, the standalone swap contracts had a negative mark-to-market value of £110 million. The resulting margin call of £88 million (net of thresholds) was primarily met by property collateral. The group monitors the impact of a 50 or 100 bps adverse movement in interest rates and has ample unencumbered assets it could post to cover adverse movements.

Sovereign's liquidity strengthened in fiscal 2020 and will remain strong, which will partially offset the increasing development and market sales risk. As of June 2020, the group had £827 million of immediately-available funds, following Sovereign's issuance of £125 million retained bonds in April 2020. In May, Sovereign also secured access to a £175 million Corporate Covid Financing Facility (CCFF) with the Bank of England. Subsequently, Sovereign's liquidity coverage ratio increased to 2.14x in FY2020, up from 0.5x in FY2019 and above the A2-rated peer median of 1.6x. The ratio is expected to remain strong over the next three years, averaging 1.5x.

Sovereign's unencumbered asset position, a measure of its long-term borrowing capacity, is strong, with an estimated value of £1.3 billion at EUV-SH (Existing Use Value for Social Housing) as of August 2020. Unencumbered assets will erode as Sovereign increases borrowing but remain solid.

Extraordinary support considerations

The strong level of extraordinary support reflects the wide-ranging powers of redressal available to the regulator in case of financial distress, with the possibility of a facilitated merger or a transfer of engagements. 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 in the increasing exposure to non-core social housing activities in the sector, which add complexity to HA operations, and the weakening in 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 links.

ESG Considerations

How environmental, social and governance risks inform our credit analysis of Sovereign

Moody's takes into account environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Sovereign, the materiality of ESG to the credit profile is as follows:

Environmental considerations are not material to HAs' credit profiles. In line with the rest of the UK, the sector's main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by country and national authorities, and therefore the financial burden of adapting to increased flood risk will not fall on individual housing associations. To address carbon transition risks, Sovereign plans to invest in its homes to achieve zero carbon by 2050.

Social risks are material to HAs' credit profiles. In particular, the sector is exposed to risks stemming from socially-driven policy agendas affecting social rents, benefits and capital grants in addition to the impact of demographic trends on demand which are captured in our assessment of the operating environment. We view the coronavirus outbreak as a social risk under our ESG framework given its impact on health and safety. Overall, we expect the outbreak to cause ongoing operational disruption for HAs but do not expect a material credit impact as higher arrears and lower market sales receipts will be offset by cash savings from reduced capital spending on development and repairs. HAs are also impacted by customer relations and product quality. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards with many HAs planning on increasing spending on the quality of their existing stock.

Governance considerations are also material to HAs' credit profiles and are captured in our assessment of governance and management. In general, housing association governance is strong with multi-year strategies supported by detailed forecasts, conservative liquidity policies, and robust risk management including stress testing.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

Rating methodology and scorecard factors

The assigned BCA of a3 is the same as the scorecard-suggested BCA.

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 3

Sovereign's 2020 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%	59,517	a
Factor 3: Financial Performance			
Operating Margin	5%	30.8%	a
Social Housing Letting Interest Coverage	10%	1.8x	baa
Cash-Flow Volatility Interest Coverage	10%	1.6x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.6x	ba
Debt to Assets	10%	50.4%	b
Liquidity Coverage	10%	2.1x	a
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**a3**

Sources: Sovereign HA, Moody's

Source: Sovereign Housing Association, Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
SOVEREIGN HOUSING ASSOCIATION	
Outlook	Stable
Issuer Rating	A2
SOVEREIGN HOUSING CAPITAL, PLC	
Outlook	Stable
Senior Secured -Dom Curr	A2

Source: Moody's Investors Service

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