S&P Global
Ratings

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Research Update:

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

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Overview

- Sovereign Housing Association Ltd. and Network Homes recently announced plans to merge, and, in our opinion, if completed, the creditworthiness of the combined group, Sovereign Network Group, would not differ materially from Sovereign's.
- However, we consider that the integration could lead to higher-than-expected costs and that the group may spend more on existing and new homes than our base-case expectations. This could strain the credit metrics beyond that of Sovereign's stand-alone financial indicators.
- We therefore affirmed our 'A+' rating on Sovereign.
- The outlook remains negative, reflecting both the risk that the group's intrinsic credit quality weakens during the merger process with Network and the outlook on the U.K.

Rating Action

On March 30, 2023 S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on Sovereign. The outlook is negative.

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 risk that the proposed merger with Network would lead to higher costs for the combined group through March 31, 2025 (fiscal 2025). Additionally, we consider that the group may increase investments in existing and new home development above our current expectations. The negative outlook also reflects the outlook on the U.K.

Downside scenario

We could lower the rating if the merger completes as planned and, over the next 24 months, management failed to contain costs linked to the integration and inflation. We think that this could weigh on S&P Global Ratings-adjusted EBITDA. Pressure on the ratings could also stem from a substantially larger maintenance and development program, which we think could weaken the debt metrics.

Furthermore, a downgrade of the U.K. (unsolicited AA/Negative/A-1+) could prompt the same action on Sovereign. We would also consider lowering the rating if we negatively reassessed our view of the likelihood of extraordinary support to Sovereign from the U.K. government in the event of financial distress.

Upside scenario

We could revise the outlook to stable if we revised the outlook on the U.K. to stable, and Sovereign performed largely in line with our base-case expectations throughout the merger process.

Rationale

The rating on Sovereign reflects our view that the group benefits from generating most of its earnings in the predictable and countercyclical social-housing sector, supported by a solid market position together with generally cautious approach to sales risk. We assume that Sovereign's very strong management will maintain solid credit metrics throughout the merger process with Network Homes, amid a period of macroeconomic and regulatory uncertainties. We assess Sovereign's management team as very experienced, with a solid background in the social housing sector. We understand that Sovereign's current chair of the board and chief executive officer will remain and continue to lead Sovereign Network Group following a potential completion of the merger. 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, and, in our view, the combined group will continue to have ample flexibility around investments in existing and new homes development, for instance, enabling the group to react to market conditions.

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.

We think that the demand for Sovereign's properties will remain solid, because its social and affordable rent levels will remain 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 the group's vacancy rates; at 1.5% on average over the past three years, we consider to be on par with the rest of the English social housing sector.

We anticipate that Sovereign will continue 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 group's home and place standard. We assume that larger bulk sales of non-core assets, albeit delayed, will occur over the coming 24 months to streamline the group's activities with a focus on affordable rent and home ownership.

We forecast that Sovereign's credit metrics will marginally strengthen compared with our previous base case. We consider that the delay of the bulk sales means that Sovereign benefits from rental revenue from these assets for longer than we had anticipated, and this strengthens its revenue base and adjusted EBITDA. Furthermore, Sovereign's investments in existing homes are lower than we had forecasted, and the group is scaling back on new homes development more than we had assumed, reducing the debt funding.

We think there is a moderately high likelihood that Sovereign would receive timely extraordinary government support if needed. Since one of the Regulator of Social Housing's (RSH's) key goals is to maintain lender confidence and low funding costs across the sector, we think it is likely that the RSH would intervene to 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 a one-notch uplift to our stand-alone credit profile on Sovereign. 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 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, on RatingsDirect).

Liquidity

We consider Sovereign's liquidity position to be strong, based on a liquidity ratio of 1.6x and our view that Sovereign has satisfactory access to external liquidity.

Sovereign's liquidity sources include:

- Forecasted cash generated from continuing operations, adding back non-cash cost of sales, of close to £215 million;
- Cash and liquidity investments of nearly £50 million;
- Undrawn and available committed bank facilities or bank lines maturing beyond the next 12 months totaling £400 million;
- Proceeds from asset sales of about £115 million; and
- Grant funding and other income of approximately £30 million.

Sovereign's liquidity uses include:

- Expected capital expenditures (capex), including development spending on units for sale, of close to £400 million; and
- Interest and maturing debt repayments of approximately £120 million.

Key Statistics

Table 1

Sovereign Housing Association Ltd.--Key Statistics

	--Fiscal year ends March 31st--				
Mil. GBP	**2021a**	**2022a**	**2023bc**	**2024bc**	**2025bc**
Number of units owned or managed	60,641	61,310	62,364	63,013	61,120
Adjusted operating revenue	414.7	419.9	438.4	499.6	517.8
Adjusted EBITDA	157.0	135.7	127.3	125.6	134.6

Table 1

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

	--Fiscal year ends March 31st--				
Mil. GBP	2021a	2022a	2023bc	2024bc	2025bc
Non-sales adjusted EBITDA	146.1	123.9	114.0	113.1	121.9
Capital expense	180.6	253.5	342.0	394.0	433.8
Debt	1,918.4	2,047.5	2,224.9	2,361.1	2,268.8
Interest expense	69.9	69.3	79.8	87.6	88.9
Adjusted EBITDA/Adjusted operating revenue (%)	37.9	32.3	29.0	25.1	26.0
Debt/Non-sales adjusted EBITDA (x)	13.1	16.5	19.5	20.9	18.6
Non-sales adjusted EBITDA/interest coverage(x)	2.1	1.8	1.4	1.3	1.4

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

Ratings Score Snapshot

Table 2

Sovereign Housing Association Ltd.--Ratings Score Snapshot

	Assessment
Enterprise risk profile	2
Industry risk	2
Regulatory framework	3
Market dependencies	2
Management and Governance	2
Financial risk profile	4
Financial performance	4
Debt profile	5
Liquidity	3

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

- U.K. Social Housing Borrowing 2023: On Pause, March 28, 2023
- Economic Outlook U.K. Q2 2023: Growth Eludes This Year Even As Inflation Eases, March 27, 2023
- Non-U.S. Social Housing Providers Ratings History: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings Score Snapshot: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings Risk Indicators: March 2023, March 27, 2023
- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022
- Non-U.S. Social Housing Sector Outlook 2023: The Most Negative Bias Since 2018 Implies Significant Pressure On Ratings, Dec. 1, 2022
- Inflation To Erode The Performance Of U.K. Public Finance Sectors, Nov. 29, 2022
- Cap On Rent Increases Is Consistent With Our Base Case For English Social Housing Providers, Nov. 17, 2022
- United Kingdom, Oct. 24, 2022
- 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
- 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
- Global Regulatory Framework Report Card: Public And Nonprofit Social Housing Providers, June 8, 2021

Ratings List

Ratings Affirmed	
Sovereign Housing Association Ltd.	
Issuer Credit Rating	A+/Negative/--
Sovereign Housing Capital PLC	
Senior Secured	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of