MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
1 December 2021

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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 (United Kingdom)

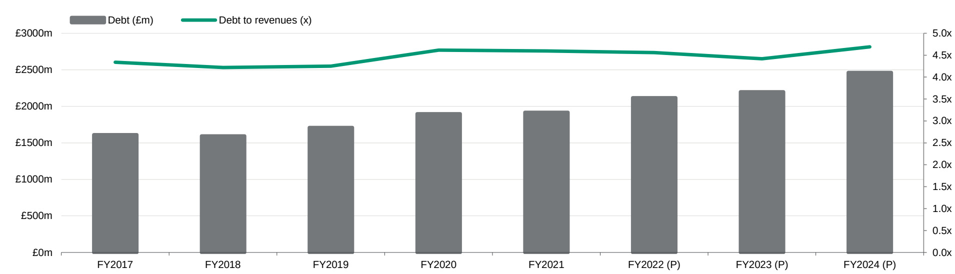
Update to credit analysis

Summary

The credit profile of Sovereign Housing Association (A2 stable) reflects its large size, strong operating margins and stable cash flows supporting solid interest cover ratios, albeit expected to weaken over the next few years. The rating also considers Sovereign's relatively higher debt levels 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 debt metrics are expected to weaken as debt rises
Debt (£m)(LHS) and debt to revenues (x)(RHS), FY2017 - FY2024(P)



P: Indicates projection
Source: Sovereign, Moody's Investors Service

Credit strengths

» Large regional housing association with strong profitability

» Strong interest covers, but expected to decline

» 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 and flexibility in adjusting its development plans. 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 materially 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 materially higher debt burdens 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-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22 (F)	31-Mar-23 (F)
Units under management (no.)	56,235	56,390	57,742	59,517	60,355	61,640	63,088
Operating margin, before interest (%)	36.6	36.3	34.9	30.8	30.1	30.2	28.6
Net capital expenditure as % turnover	33.0	17.8	28.1	44.8	14.0	75.9	91.1
Social housing letting interest coverage (x times)	1.8	2.1	2.0	1.8	1.5	1.7	1.5
Cash flow volatility interest coverage (x times)	2.0	2.3	2.8	1.6	2.0	2.1	2.3
Debt to revenues (x times)	4.3	4.2	4.3	4.6	4.6	4.6	4.4
Debt to assets at cost (%)	52.0	49.5	49.9	50.4	49.3	50.7	49.1

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 large regional housing association concentrated in the South of England with over 60,000 units owned and managed as of the end of fiscal 2021. Whilst 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 30% in fiscal 2021 was in line with the A2-rated peer median of 30% (fiscal 2021). The strong profitability was driven by high margins on its social housing lettings, for which the group reported a margin of 34% in fiscal 2021 compared to 14% on its market sales for the year. According to its 2021 business plan, Sovereign's operating margin is expected to remain stable, averaging 29% over the next three years. Whilst Sovereign's exposure to market sales as a percentage of turnover (including joint ventures, JVs) is expected to rise to 29% in fiscal 2026 from 19% in fiscal 2021, the lower profitability from this revenue source is expected to be offset by strong margins on social housing lettings. Social housing lettings margin is expected to remain strong, averaging 35% over the next three years, underscoring the profitability of the core social housing business.

Strong interest covers, but expected to decline going forwards

Sovereign's strong operating performance has supported its stable cash flows and solid interest cover ratios. The strong projected performance on its operating 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, whilst 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 2023/2024 onwards. These investments will help improve the condition of its asset base over time to meet its new Home and Place Standard. As part of the standard, Sovereign is aiming to upgrade all of its core rented homes to an average EPC C across its stock by 2035 and is targeting EPC B+ by 2050. Sovereign has included a provision of £576 million across the life of its business plan to achieve these targets.

Sovereign's social housing lettings interest cover (SHLIC), which measures the cover of cash interest payments from social housing letting surplus, was 1.5x in fiscal 2021, broadly in line with the A2-rated peer median of 1.6x (fiscal 2021). Whilst SHLIC is expected to improve in fiscal 2022 as the association is able to increase social rents by CPI + 1%, as the association plans to focus more on other activities and take on additional debt, its SHLIC is expected to weaken over the next few years, declining to 1.3x by FY2025.

Despite its significant market sales programme, Sovereign's operating cash flow (CFO) is expected to remain relatively stable, if it achieves the assumed level of market sales in its plan. Its cash flow volatility interest cover (CVIC) strengthened in fiscal 2021 to 2.0x from 1.6x in fiscal 2020, driven by the sale of properties held as stock and no new loans to joint ventures, which increased Sovereign's adjusted CFO to £177 million in fiscal 2021 from £124 million in fiscal 2020. Over the next three years, we expect CVIC to remain stable at an average 2.2x as increased operating cash flows from market sales and disposals receipts are offset by higher net interest costs.

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. 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 missed its previously-planned target of delivering 1,900 homes in fiscal 2021, instead achieving 1,100 new homes. Due in part to supply constraints, its development programme continues to be slower than expected in fiscal 2022 and the association expects to complete a similar number of new homes as the previous year. Sovereign, however, continues to plan for higher completions going forward; the increase in development spending and risk is captured in the net capital expenditure (capex) to revenues ratio, which is projected to average 81% over the next three years, having averaged 47% over fiscals 2019-21 (though may be slightly lower in fiscal 2022 given development delays). This is significantly above the rated peer median in fiscal 2021 of 14%, illustrating the significant spending on development and on existing stock.

The development programme incorporates several tenures including social and affordable rent, shared ownership and outright sales (both through Sovereign and through joint ventures). Over the next five years, 7% will be outright sales, 33% shared ownership, 31% affordable housing and 29% general needs rent. New units coming online, in addition to inflation-linked rents, will support steady revenue growth, increasing to £525 million by fiscal 2024 (including revenues from JVs), up from £417 million in fiscal 2021.

Over the last two years, 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 have included a placeholder for £200m to potentially invest in longer-term land investment opportunities.

Sovereign plans to develop approximately 4% of its market sales programme through JVs over the next five years. Its development plans from fiscal 2027 aim to increase development to over 2,400 a year through additional regeneration projects and Strategic Asset Management replacement units. Sovereign have identified additional placeholders for regeneration in the current iteration of its plan, with a target of around 3,800 homes earmarked for regeneration over 10 years compared to 1,750 units last year.

Sovereign's exposure to market sales will continue to grow modestly over the next five years, as the HA develops its shared ownership and open market sales units. Total sales, including JVs, as a percentage of turnover remained stable in fiscal 2021 at 19%, slightly down from 20% in FY2020, despite the impact of Covid-19. This metric is set to increase year-on-year, rising to 29% by FY2026 as Sovereign completes units and sales volumes pick up.

We expect Sovereign will continue to effectively manage its increased development programme. Whilst the business plan incorporates an increase in market sales activity, Sovereign's financial standards limit the amount of exposure, although we note the tolerance increased in the past two years to a limit of 40% total sales as a percentage of revenues, from 35% and 30% previously. We expect, however, that Sovereign's sale exposure will remain well below this limit; if it were to reach close to this limit, this would be credit negative.

Sovereign has significant flexibility in its development programme and its business plan. Only around a quarter of its planned development spend over the next five years is committed and if Sovereign were not able to achieve the asset disposals it is targeting, it would reduce its development programme. 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 five years, the group's debt ratios will weaken due to accelerated debt growth to fund its increased development output. As of fiscal 2021, Sovereign's debt (net of cash) of £1.8 billion was equivalent to 4.6x revenue and 49% of assets at cost (gearing), compared with the A2-rated peer medians of 4.1x and 48%, respectively. Debt will increase, projected to reach £2.6 billion by fiscal 2025, which will weigh on debt ratios. Debt to revenues will rise to 4.9x by fiscal 2025 and gearing will increase to 51% in the same period. However, we note that Sovereign includes in its business plan assumptions of a significant portion of uncommitted development as being debt-financed; we expect that the increase in debt will likely be slower than projected as some of these development plans may not complete as planned or may be financed in other ways.

Management uses standalone interest rate swaps for hedging (notional amount of £245 million), including some inflation and LIBOR linked swaps, which introduces the risk of margin calls and consequent collateral posting. As of August 2021, the standalone swap contracts had a negative mark-to-market value of £89 million. The resulting margin call of £70 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 coverage weakened in fiscal 2021 considering its increased development plans (which includes uncommitted development) and is expected to remain weaker as it uses its facilities to execute its development programme. As of FYE2021, the group had £719 million of immediately-available funds, supported by the issuance of its £125 million retained bonds in April 2020. In May 2020, Sovereign also secured access to a £175 million Corporate Covid Financing Facility (CCFF) with the Bank of England, to ensure the housing association had adequate liquidity if needed. Sovereign's liquidity coverage ratio decreased to 0.9x in FY2021, down from 2.0x in FY2020 and below the A2-rated peer median of 1.3x as the two years projected net cash need rises with planned development. Subsequently, the ratio is expected to remain weaker over the next three years, averaging 0.8x as net capital expenditures increase.

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 June 2021. 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 Sovereign's credit profile. 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. Sovereign, like many in the sector, face costs related to carbon transition. Sovereign includes in its business plan investment in its homes to achieve net zero carbon by 2050.

Social risks are material to Sovereign's credit profile. In particular, the housing association 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. HAs are also affected by customer relations and responsible production. The Grenfell fire tragedy in June 2017 has encouraged higher fire and building safety standards with many HAs planning on increasing spending on the quality of their existing stock.

Governance considerations are also material to Sovereign's credit profile 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 close to 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 2021 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%	60,355	a
Factor 3: Financial Performance			
Operating Margin	5%	30.1%	a
Social Housing Letting Interest Coverage	10%	1.5x	a
Cash-Flow Volatility Interest Coverage	10%	2.0x	baa
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.6x	b
Debt to Assets	10%	49.3%	b
Liquidity Coverage	10%	0.9x	a
Factor 5: Management and Governance			
Financial Management	10%	baa	baa
Investment and Debt Management	10%	baa	baa
Suggested BCA			**baa1**

Source: Sovereign, 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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