S&P Global Ratings

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Research Update:

U.K.-Based Sovereign Housing Association Ltd. Affirmed At 'A+'; Outlook Stable

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Overview

- We estimate that U.K.-based Sovereign Housing Association Ltd. (Sovereign) has reduced its exposure to sales risks over the next three years, supported by a consistent strategy and solid risk management.
- However, in our view, increasing levels of investments into the existing stock will add some pressure to the group's profitability, but we expect that the group's debt service credit metrics will remain relatively strong, albeit on a declining trend.
- We affirmed our 'A+' long-term issuer credit rating on Sovereign.
- The outlook is stable.

Rating Action

On Oct. 18, 2021, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K. social housing provider Sovereign Housing Association Ltd. (Sovereign). The outlook is stable.

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.

Rationale

The affirmation reflects our view that 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 consider the management to have built-in flexibility in the planning process, as evidenced by the group's capacity to scale back or pause development onsite in fiscal year (FY) ending March 31, 2021, and FY2020 without a major impact on profitability. We think that the demand for Sovereign's properties will remain solid, because its social and affordable rent levels are low, at just above 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 generally low vacancy rates. The voids were 1.1% of the rent revenues in FY2020, rising to 1.7% in 2021 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. We consider this to be a temporary increase and forecast that Sovereign's void rates will reduce.

We forecast that Sovereign's profitability will come under pressure over the coming years, but this is mainly the result of increasing investments in the existing asset base. Because we consider these investments to be operating costs, they affect the group's S&P Global Ratings-adjusted EBITDA margins. We expect the group's adjusted EBITDA margins will decline in FY2021 and will remain about 30% through FY2024, compared with about 35% over the previous two years.

We anticipate that Sovereign will continue to increase expenditure to improve the safety and condition of existing stock, because the group targets a higher home and place standard to work toward achieving the 2050 zero carbon objective. Sovereign also employs an asset management strategy to dispose of noncore units and dispose and replace rental units that do not fit in with the new home and place standard, and we understand that larger bulk sales are being considered over the coming 12 months to streamline its core activities with a focus on affordable rent and home ownership.

Over time, we think the group's homes will be well positioned to meet future consumer, environmental, and construction regulations, reducing both enterprise and financial risks in the longer term.

While we have built into our forecast a significant amount of sale proceeds from the sale of existing homes, and we also consider the grant funding being available from Homes England, both in the previous allocation and the recently announced program, we think that Sovereign would need to debt fund some of the development spend. We forecast that the group's debt service metrics will remain relatively strong, albeit on a declining trend, with non-sales EBITDA interest coverage falling below 1.6x in FY2024, from 2x in FY2021, and the debt/nonsales EBITDA ratio edging up to more than 18x during the same period, from 13x in FY2021.

We assess the regulatory framework under which registered providers of social housing in England operate as strong, underpinned by their public policy mandate to provide affordable homes. We also consider that the sector benefits from solid ongoing oversight by the Regulator for Social Housing (RSH). These strengths are offset, in our view, by the relatively low levels of grant funding that the providers in England receive for the development of affordable homes. We consider that providers in England can develop homes for outright sale, using the proceeds as an alternative funding source; that said, we think that this exposes them to risks and potential volatility compared with providers in other regions. Providers in England are also subjected to negative intervention from the U.K. government in the form of constraints on rent setting or additional spending responsibilities, without adequate additional funding. In our view, this weighs on the regulatory framework assessment.

We believe there is a moderately high likelihood that Sovereign would receive extraordinary support from the government via the RSH in case of financial distress. This is neutral to the rating which is at the same level as the stand-alone credit profile (SACP). As one of the key goals of the RSH is to maintain lender confidence and low funding costs across the sector, we believe the RSH is likely to step in to try and prevent a default in the sector. The RSH has a record of mediating mergers or arranging liquidity support from other registered providers in cases of financial distress and we think this would apply to Sovereign.

Liquidity

We consider Sovereign's liquidity position to be very strong, thanks to its high levels of undrawn credit facilities, solid cash flow generation, and satisfactory access to capital markets. In our base case, we estimate that sources of cash will cover uses by more than 2.6x over the next 12 months. However, the sources include estimated proceeds from the bulk sale of existing assets, which is a funding source that may not be sustained over time.

Liquidity sources include:

- Forecast cash generated from continuing operations, adding back noncash cost of sales, exceeding £200 million;
- Cash and liquidity investments of about £30 million;
- Undrawn and available committed bank facilities or bank lines maturing beyond the next 12 months totaling £660 million;
- Proceeds from asset sales, incorporating expected bulk sales of existing homes; and
- Grant funding and other income of about £35 million.

Liquidity uses include:

- Expected capital expenditure (capex), including development spend on units for sale exceeding £440 million; and
- Interest and maturing debt repayments of more than £100 million.

Outlook

The stable outlook reflects our view that Sovereign's exposure to sales risk, supported by the management's strategy, will be contained to less than a third of the group's revenue, while maintaining credit metrics in line with our base-case expectations.

Downside scenario

We could lower the rating should investments in the asset base put greater pressure on the group's profitability, or if the development of units for sale increased, resulting in adjusted EBITDA margins dropping materially below 30%. Pressure on the rating could also come from weaker debt metrics, should Sovereign need to debt fund more of its capex in the absence of proceeds from asset sales.

Upside scenario

An upgrade would depend on Sovereign's financial performance strengthening significantly, with adjusted EBITDA margins exceeding 35%, supporting a material improvement of the group's credit metrics, including debt/nonsales adjusted EBITDA and non-sales adjusted EBITDA interest coverage moving toward 15x and 2x, respectively.

Key Statistics

Table 1

Sovereign Housing Association Ltd.--Key Statistics

	--Year ended March 31st--				
Mil. £	**2020a**	**2021a**	**2022e**	**2023bc**	**2024bc**
Number of units owned or managed	59,681	60,538	60,568	59,360	60,292
Adjusted operating revenue	408.6	414.7	412.1	444.4	465.0
Adjusted EBITDA	139.4	157.0	134.2	136.3	131.4
Non-sales adjusted EBITDA	124.6	146.1	127.0	128.4	122.0
Capital expense	267.7	180.6	334.4	546.7	606.1
Debt	1,897.1	1,918.4	1,988.4	2,008.4	2,238.4
Interest expense	68.6	73.3	73.2	74.1	77.5
Adjusted EBITDA/Adjusted operating revenue (%)	34.1	37.9	32.6	30.7	28.3
Debt/Non-sales adjusted EBITDA (x)	15.2	13.1	15.7	15.6	18.3
Non-sales adjusted EBITDA/interest coverage(x)	1.82	1.99	1.74	1.73	1.57

a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Ratings Score Snapshot

Table 2

Sovereign Housing Association Ltd.

	Assessment
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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

- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers Published, June 8, 2021
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 23, 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 Association Ltd.	
Issuer Credit Rating	A+/Stable/--
Sovereign Housing Capital PLC	
Senior Secured	A+