S&P Global Ratings

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Research Update:

Sovereign Housing Association Downgraded To 'A'; Outlook Negative

November 22, 2023

Overview

- We project that U.K.-based social housing provider Sovereign Housing Association Ltd., now known as Sovereign Network Group (SNG) following its merger with Network Homes as of Oct. 1, 2023, will continue to partially debt fund the development of new homes.
- At the same time, we expect SNG to invest more in existing homes than we previously anticipated.
- In combination with cost inflation and rising interest rates, this will weaken SNG's credit metrics, in our view.
- We therefore lowered our long-term issuer credit rating on SNG to 'A' from 'A+'. The outlook is negative.

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Rating Action

On Nov. 22, 2023, S&P Global Ratings lowered to 'A' from 'A+' its long-term issuer credit rating on Sovereign Housing Association Ltd., now known as Sovereign Network Group (SNG). The outlook is negative.

At the same time, we lowered to 'A' from 'A+' our 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 SNG, and we view it as a core subsidiary of SNG.

Outlook

The negative outlook reflects the risk that increasing investments in existing and new homes will prevent SNG's credit metrics from strengthening over the next 24 months.

Downside scenario

We could lower the rating if management increases investments in existing and new homes more than we currently assume under our base case. We think that this could sustainably weigh on SNG's financial performance and debt metrics.

Upside scenario

We could revise the outlook to stable if SNG performs largely in line with our base-case expectations, supported by a clear strategy on how to mitigate the impact from economic and regulatory external factors. We consider that this could lead to gradual improvement of the group's financial indicators.

Rationale

The downgrade of SNG reflects our projections that the group's debt-funded development program and steadily increasing investments in existing homes will weaken its credit metrics more than previously assumed.

Enterprise profile: Supported by large asset base, solid operational metrics, and contained sales risk

The rating on SNG is underpinned by 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 and generally cautious approach to sales risk.

SNG owns and manages 85,000 homes, which should bring economies of scale and enable the group to better withstand external shocks than smaller social housing providers. The group continues to see strong demand for its properties, supported by average social and affordable rents, which are just above 50% of the prevailing market rent in the regions in which it operates--across London and the south of England. In our view, the group's vacancy rate of 1.8% on average over the past three years is on par with the rest of the English social housing sector. We also note that SNG continues to work to bring all its homes to the Energy Performance Certificate (EPC) C level by 2030, with about 70% of its stock already at EPC C or above.

We assume SNG's sales risk will be contained at less than one-third of turnover, supported by the group's consistent strategy and solid risk management.

In our view, SNG's board and executive team have solid experience in managing social housing providers, supported by strong governance and treasury practices. Contrary to many peers, SNG continues to deliver on a relatively large new homes development plan while increasing investments in existing homes. In our view, this adds pressure to credit metrics. That said, we consider management to have built-in flexibility around investments in existing and new homes, as demonstrated by the group's capacity to scale back or pause development in recent years. We understand that only 33% of SNG's development program over the next three years is committed and that the group's planned investments in existing homes includes provisions and potential spend that could be phased out into later years.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (see "Regulatory Framework Assessment: Social Housing Providers In

The U.K. Benefit From Strong Regulatory Frameworks," published Oct. 23, 2023, on RatingsDirect).

Financial profile: Weakening credit metrics due to increasing investments in existing and new homes amid cost inflation and higher interest rates.

We forecast that the group's S&P Global Ratings-adjusted EBITDA margins will weaken due to a significant increase in investments in existing homes. We project the group's adjusted EBITDA margins will average about 21% over the next three years to March 31, 2026 (fiscal 2026). This is weaker than our previous base case for Sovereign Housing before the merger of about 25% over fiscals 2024 and 2025, and significantly lower than the average for SNG on a consolidated basis of close to 30% over the past three years.

At the same time, we project that the group's debt metrics will weaken as it continues to debt fund the development of new homes and interest rates are higher than in prior years. We calculate that 20% and 9% of Sovereign's and Network's respective debt was at variable rates as of March 31, 2023, and with higher underlying rates projected in fiscal 2024 and 2025, this will negatively affect SNG's interest costs. In combination with steadily increasing debt, we forecast that the group's adjusted nonsales EBITDA interest coverage and debt to adjusted nonsales EBITDA ratios will average 1.0x and 27x over the next three years through fiscal 2026. This is weaker than our previous base case for Sovereign on a stand-alone basis of about 1.5x, and 19x and for the combined group over the past three years.

We consider SNG's liquidity position to be strong. This is based on a liquidity ratio of 1.4x, our understanding that SNG is in the process of placing more credit facilities, and our view that it has satisfactory access to external liquidity. We forecast liquidity sources of about £1.1 billion--mainly via cash from operations after adding back the noncash cost of sales, cash, and undrawn available facilities; grant receipts; and sales proceeds from fixed asset sales. This compares with liquidity uses of about £790 million--primarily capital expenditure, interest, and principal repayments.

Government-related entity analysis

We think there is a moderately high likelihood that SNG would receive timely extraordinary government support if needed. This leads us to apply a one-notch uplift to the stand-alone credit profile (SACP) to derive the issuer credit rating. Since one of the key goals of the Regulator of Social Housing (RSH) is to maintain lender confidence and low funding costs across the sector, we think it is likely that the RSH would step in and try and 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 SNG.

Selected Indicators

Table 1

Sovereign Network Group--Financial statistics (*)

	--Year ended March 31--				
Mil. £	**2022a**	**2023a**	**2024bc**	**2025bc**	**2026bc**
Number of units owned or managed	83,695	84,943	86,067	86,873	87,434
Adjusted operating revenue	625.3	676.2	740.7	796.9	796.7
Adjusted EBITDA	191.6	154.6	150.9	165.4	187.8

Table 1

Sovereign Network Group--Financial statistics (*) (cont.)

	--Year ended March 31--				
Mil. £	**2022a**	**2023a**	**2024bc**	**2025bc**	**2026bc**
Nonsales adjusted EBITDA	178.4	140.0	131.8	148.5	170.6
Capital expense	409.9	431.7	599.2	610.6	624.8
Debt	3187.5	3429.5	3667.0	3922.0	4122.0
Interest expense	109.4	121.7	138.6	145.1	146.5
Adjusted EBITDA/Adjusted operating revenue (%)	30.6	22.9	20.4	20.8	23.6
Debt/Nonsales adjusted EBITDA (x)	17.9	24.5	27.8	26.4	24.2
Nonsales adjusted EBITDA/interest coverage(x)	1.6	1.2	1.0	1.0	1.2

a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available. (*) 2022a and 2023a represent combined Sovereign Housing Association and Network Homes Limited accounts

Ratings Score Snapshot

Table 2

Sovereign Network Group--Ratings Score Snapshot

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Financial performance	4
Debt profile	5
Liquidity	3
Stand-alone credit profile	a-
Issuer credit rating	A

S&P Global Ratings bases its ratings on nonprofit social housing providers on the seven main rating factors listed in the table above. Our "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

- Non-U.S. Social Housing Providers Ratings Score Snapshot November 2023, Nov. 15, 2023
- Non-U.S. Social Housing Providers Ratings Risk Indicators: November 2023, Nov. 15, 2023
- Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks, Oct. 23, 2023
- U.K. Social Housing Providers' Credit Headroom Could Tighten If The Operating Environment Deteriorates, Oct. 4, 2023
- U.K. Social Housing Borrowing 2023: On Pause, March 28, 2023
- Non-U.S. Social Housing Providers Ratings History: 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

Ratings List

Downgraded

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