MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
16 October 2019

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RATINGS

Sovereign Housing Association

Domicile	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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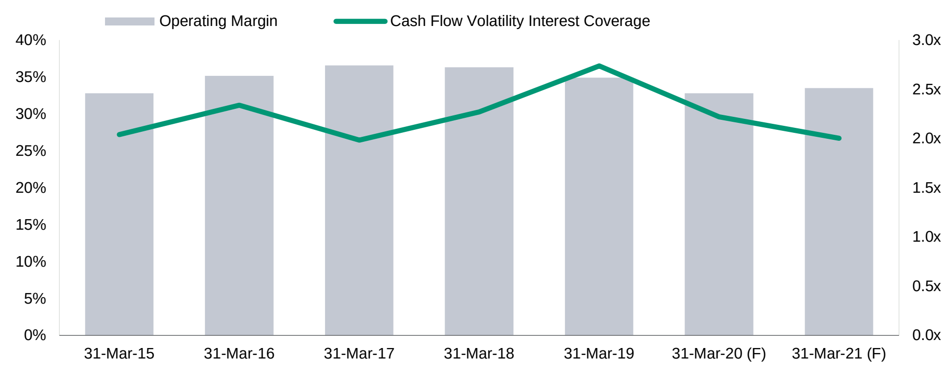
Sovereign Housing Association (UK)

Update to credit analysis

Summary

The credit profile of Sovereign Housing Association (Sovereign, A2 stable) reflects its large size, strong operating margin and stable cash flows supporting solid interest cover ratios. The rating also takes into account 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 United Kingdom (Aa2 stable) would intervene in the event that Sovereign faces acute liquidity stress.

Exhibit 1
Sovereign's strong and stable operating performance is expected to continue
Operating margin (%) and cash flow volatility interest coverage (x), fiscal 2015-21



Sources: Moody's Investors Service, Sovereign

Credit strengths

» Large regional housing association with strong profitability

» Stable cash flows supporting 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 and financial management. 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 1.3x.

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, a deterioration in its liquidity coverage ratio or a weakening in the social housing lettings interest cover (SHLIC) to levels below 1.5x on a sustained basis. Moreover, a dilution of regulatory oversight, government support, or a downgrade of the UK sovereign rating could also exert downward pressure on Sovereign's rating.

Key indicators

Exhibit 2

Sovereign Housing Association

	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20 (F)	31-Mar-21 (F)
Units under management (no.)	36,188	36,620	56,235	56,390	57,742	58,088	59,787
Operating margin, before interest (%)	32.8	35.1	36.6	36.3	34.9	32.8	33.5
Net capital expenditure as % turnover	41.7	24.8	33.0	17.8	29.1	66.3	52.4
Social housing letting interest coverage (x times)	1.5	1.8	1.8	2.1	2.0	1.5	1.4
Cash flow volatility interest coverage (x times)	2.0	2.3	2.0	2.3	2.7	2.2	2.0
Debt to revenues (x times)	5.1	5.0	4.3	4.2	4.3	4.7	5.1
Debt to assets at cost (%)	54.2	53.7	52.0	49.5	49.9	51.5	52.5

Figures for fiscal 2019 and fiscal 2020 are forecast figures. Figures for fiscal 2015 and onwards are prepared in FRS102 format, while the previous years' figures were prepared using the old UK GAAP.
Sources: Moody's, Sovereign

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 faces acute liquidity stress.

Baseline credit assessment

Large regional housing association with strong profitability

Sovereign's merger with Spectrum Housing Association in 2016 enhanced its position as a strong regional housing association with political influence. The combined entity has nearly 58,000 units owned and managed as of the end of fiscal 2019, concentrated in South West England. The group's strategy highlights its public affairs and research programme, through which the organisation plans to influence policy.

Sovereign's operating margin of 35% in fiscal 2019 was well above the A2-rated peer median of 29% (fiscal 2018). The very strong profitability is driven by high margins on its social housing lettings, for which the group reported a margin of 40% in fiscal 2019 compared to 21% on its market sales for the year. Sovereign's operating margin is expected to weaken slightly but remain strong relative to that of its peers, averaging 33% over the next three years. Pressure on margins will mainly result from an increase in less profitable market sales. Forecasted margins on market sales are achievable and in line with past performance, expected in the range of 15%-21% over the next few years.

Stable cash flows supporting strong interest cover ratios

Sovereign's strong operating performance supports its stable cash flows and solid interest cover ratios. Despite its growing market sales programme, Sovereign's operating cash flow is expected to remain relatively stable. Its cash flow volatility interest cover (CVIC) strengthened in fiscal 2019 to 2.7x from 2.3x in fiscal 2018, and compares favourably to the A2-rated peer median of 1.9x (fiscal 2018). CVIC is expected to weaken slightly but remain strong, averaging 2.0x over the next three years.

Sovereign's social housing lettings interest cover (SHLIC), which measures the cover of cash interest payments from social housing letting surplus, was 2.0x in fiscal 2019, slightly above the A2-rated peer median of 1.9x (fiscal 2018). However, as the association plans to focus more on non-social housing letting activities and take on additional debt, its SHLIC is expected to weaken, averaging 1.4x over the next three years.

Management aim for realistic and accurate budgets and forecasts, with minimal contingencies. However, one area of conservatism is the group's assumption for the cost of new borrowing which is likely to result in savings on actual interest expense compared to forecasts which would in turn marginally boost interest cover ratios.

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 for large and complex HAs. Additionally, 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 will 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, a target the group expects to reach in fiscal 2020. Development output is then expected to remain stable around 1,900 home per year for next five years. The increase in development spending and risk is captured in the net capital expenditure (capex) to revenues ratio, expected to peak at 66% in fiscal 2020 compared to an A2-rated peer median of 20% (fiscal 2018).

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% per year over the next three years, reaching £465 million by fiscal 2022, up from £402 million in fiscal 2019.

Over the last year, the group has modified its development strategy in a few areas. Sovereign is looking to shift more toward land-led development (with a target of 50% land-led by 2024) which will give it more control over sites. The group has also significantly reduced plans build units for market rent. Lastly, Sovereign exited one underperforming joint venture (JV) with minimal cost to the group. Sovereign plans to develop approximately 4% of its development programme through JVs over the next five years.

Sovereign's exposure to market sales will continue to grow modestly in the next year, reaching 22% of turnover in fiscal 2020, up from 19% in fiscal 2019. Over the next three years, first-tranche shared ownership sales income will account for a larger proportion of market sales income than riskier outright sales. Assumptions for profitability on market sales are attainable, averaging 19% over the next three years compared with a realised result of 21% in fiscal 2019.

Although the business plan incorporates an increase in market sales activity, Sovereign's financial standards limit the amount of exposure, a credit positive, although the tolerance increased in the year to a limit of 35% (up from 30% the year before). While a shift in the limit is credit negative, overall, a board-established limit for market sales is credit positive as it caps the amount of risk-taking in the organisation. Moreover, exposure will remain well below the limit over the next few years.

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 2019, Sovereign's debt (net of cash) of £1.7 billion was equivalent to 4.3x revenue and 50% of assets at cost (gearing), compared with the A2-rated peer medians of 3.6x and 40%, respectively. Debt will increase reaching £2.3 billion by fiscal 2022 which will negatively impact debt ratios. Debt to revenues will rise to 5.1x by fiscal 2021 and gearing will increase to 54% by fiscal 2022.

Management uses standalone interest rate swaps for hedging (notional amount of £356 million), including some inflation and LIBOR linked swaps, which introduces the risk of margin calls and consequent collateral posting. As of May 2019, the standalone swap contracts had a negative mark-to-market value of £92 million. The resulting margin call of £71 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 will strengthen in fiscal 2020 and remain strong, which will partially offset the increasing development and market sales risk. As of June 2019, the group had £445 million of immediately-available funds which will grow to £540 million by year end. The increased liquidity will improve the liquidity coverage ratio to 1.3x in fiscal 2020 from 0.5x in fiscal 2019. The ratio is expected to strengthen further to 1.6x by fiscal 2022, which will compare favourably to the A2-rated peer median of 1.1x (fiscal 2018).

Sovereign's unencumbered asset position, a measure of its long-term borrowing capacity, is strong, with an estimated value of £1.2 billion at EUV-SH (Existing Use Value for Social Housing) as of June 2019. Unencumbered assets will erode as Sovereign increases borrowing but remain solid.

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 risks are not material to Sovereign's credit profile. In line with the rest of the UK, its main environmental risk exposures relate to water shortage and flood risk. Flood risk is management by country and national authorities, and therefore the burden of adapting to increased flood risk will not fall on Sovereign.

Social risks are material to Sovereign's credit profile in line with the rest of the UK housing association sector. In particular, the sector is exposed to risks stemming from socially-driven policy agendas and is also affected by the impact of demographic trends and customer relations on demand. Socially-driven policy agendas can be positive or negative for the sector. The broad political support for social housing is captured in our analysis of the operating environment. On the other hand, central government's policy to increase the affordability of rents for low-income social housing tenants led to four years of sector-wide rent cuts from fiscal 2017 which was credit negative for the sector. Customer relations and product quality can also have an impact on housing associations. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards, and led many housing associations to increase spending on the quality of their existing stock.

Governance considerations are also material to Sovereign's credit profile. Sovereign's governance and management are strong, underpinned by a broadly stable strategy and solid financial reporting. English housing associations also benefit from a strong regulatory framework and close oversight by the Regulator of Social Housing, as detailed in the main body of this report.

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.

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.

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 June 2018.

Exhibit 4

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%	57,742	a
Factor 3: Financial Performance			
Operating Margin	5%	34.9%	a
Social Housing Letting Interest Coverage	10%	2.0x	aa
Cash-Flow Volatility Interest Coverage	10%	2.7x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.3x	ba
Debt to Assets	10%	49.9%	ba
Liquidity Coverage	10%	0.5x	ba
Factor 5: Management and Governance			
Financial Management	10%	a	a
Investment and Debt Management	10%	baa	baa
Suggested BCA			**a3**

Sources: Moody's, Sovereign

Ratings

Exhibit 5

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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