MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
29 September 2017

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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

## Update following downgrade to A2, outlook changed to stable

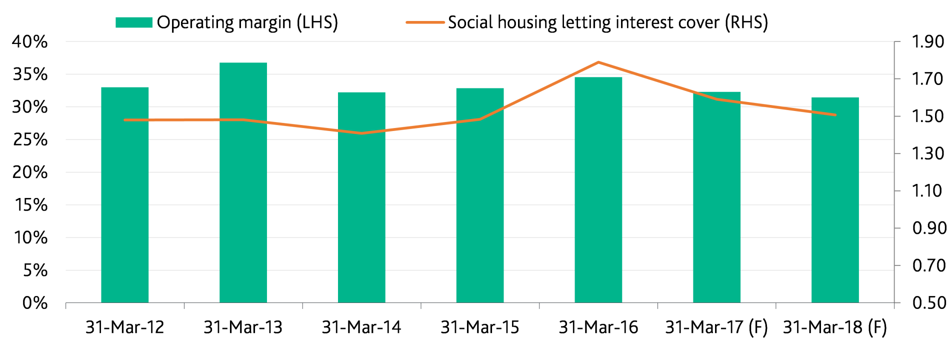
## Summary Rating Rationale

The A2 issuer rating assigned to Sovereign Housing Association (Sovereign) reflects its (1) strong operating margins (2) stable cash flows supporting solid interest cover ratios, (2) strong management practices including adherence to internal "financial standards"; and (3) solid liquidity position supported by ample unencumbered assets. The rating also takes into account its (1) moderately higher debt level, and (2) moderate exposure to market sales, and (3) relatively complex group structure post merger.

The A2 rating also benefits from the strong regulatory framework governing English housing associations and our assessment that there is a strong likelihood that the UK government (Aa2 stable) would intervene in the event that Sovereign faced acute liquidity stress.

Sovereign is rated at the upper end of Moody's-rated English housing associations, whose ratings span from A1 to Baa2. Sovereign's relative position reflects stronger margins and stable cash flows, and high level of unencumbered assets, but also its moderately higher level of debt and increasing exposure to market sales.

Exhibit 1
**Sovereign's strong and stable performance is expected to continue**




*Source: Moody's, Sovereign's financial statements*

## Credit Strengths

» Large regional player with strong profitability

» Stable cash flow supporting strong interest cover ratios

» Solid liquidity position underpinned by ample unencumbered assets

» Strong regulatory framework

## Credit Challenges

» Rising, but moderate, market sales exposure in the business plan

» Relatively high level of debt

» Operating environment remains challenging but policy is more stable

## Rating Outlook

The stable outlook on Sovereign Housing Association reflects the currently stable operating environment, which is unlikely to undergo further material change in the medium-term, and the stable outlook on the sovereign rating.

## Recent Developments

On September 26th 2017, Sovereign Housing Association's rating was downgraded to A2 from A1 to reflect the close institutional, operational and financial linkages between the central government and UK housing associations (HAs), and the reduced financial resilience of the sovereign as captured by Moody's recent decision to downgrade the UK's sovereign rating to Aa2 from Aa1. The outlook has been changed to stable from negative to reflect the stable outlook on the sovereign rating, and the HA sector adapting well to a challenging policy environment, which is not expected to undergo further material change in the medium-term.

## Factors that Could Lead to an Upgrade

One or a combination of the following could have positive rating implications:

» Reduction in gearing (debt to assets)

» Reduction in market sales activity

» Overcoming merger execution risks

## Factors that Could Lead to a Downgrade

One or a combination of the following could have negative rating implications:

» Material scaling up of the development programme leading to increased debt

» Weakening of historically strong interest cover ratios

» Deterioration in its adequate liquidity and strong unencumbered assets position

» Weaker regulatory framework, a dilution of the overall level of support from the UK government or a downgrade of the UK sovereign rating would also exert downward pressure on the rating

## Key Indicators

Exhibit 2

| | 31-Mar-12 | 31-Mar-13 | 31-Mar-14 | 31-Mar-15 | 31-Mar-16 |
|---|---|---|---|---|---|
| Units under management (no.) | 32577 | 34825 | 35814 | 36188 | 36620 |
| Operating margin, before interest (%) | 33% | 37% | 32% | 33% | 35% |
| Net capital expenditure as % turnover | 41% | 74% | 21% | 42% | 25% |
| Social housing letting interest coverage (x times) | 1.5 | 1.5 | 1.4 | 1.5 | 1.8 |
| Cash flow volatility interest coverage (x times) | 2.0 | 1.7 | 2.0 | 2.0 | 2.3 |
| Debt to revenues (x times) | 5.1 | 5.3 | 4.9 | 5.1 | 4.9 |
| Debt to assets at cost (%) | 49% | 50% | 50% | 54% | 54% |

*Source: Moody's, Sovereign's financial statements*

## Detailed Rating Considerations

Sovereign's rating combines (1) its baseline credit assessment (BCA) of a3 and (2) a strong likelihood of extraordinary support coming from the UK government in the event that Sovereign's faced acute liquidity stress.

### Baseline Credit Assessment

LARGE REGIONAL PLAYER WITH STRONG PROFITABILITY

Sovereign's merger will enhance its position as a strong regional player with political influence, in addition to opportunities for material operational savings. The combined entity will have 56,000 units concentrated in South West England.

The size and geographic concentration will enable Sovereign to realise efficiencies and benefit from economies of scale. Pre-merger, both entities targeted savings in their business plans (GBP16 million in Sovereign and GBP8 million in Spectrum). In addition to entity-specific plans for savings, the merged entity is expected to reduce costs by a further GBP10 million through synergies. The merged entity expects to deliver 50% of the total savings of GBP34 million by the end of FY2017, with the remaining savings made over the course of the five-year business plan.

Going forward, operating margins will weaken slightly but remain strong relative to peers, averaging 32% over the next five years. Sovereign's operating margin was 35% in FY2016, which was above the Moody's-rated peer median of 28% in FY2015. Pressure on margins going forward will result from the impact of the rent cut and the merger with Spectrum, whose margins have historically been weaker than Sovereign's.

STABLE CASH FLOWS SUPPORTING STRONG INTEREST COVER RATIOS

Sovereign's focus on the core social housing landlord business will continue to generate stable cash flows, a credit positive. Sovereign's revenues grew by 5% to GBP235 million in FY2016, driven by modest growth of both social housing lettings and first tranche shared ownership sales. Going forward, turnover is expected to grow steadily in both core and non-core activities, with turnover of the merged entity forecasted to grow from GBP357 million in FY2017 to GBP415 million by FY2021.

Sovereign's strong profitability drives its above average interest cover ratios. The association's social housing lettings interest cover (SHLIC) of 1.8x in FY2016 was higher than the Moody's-rated peer median of 1.3x, and improved from 1.4x in FY2014. Sovereign's SHLIC is expected to remain strong, averaging 1.5x over the next five years as growth in the surplus from social housing lettings outpaces growth in interest payments.

Sovereign's stable cash flows are reflected in its strong cash flow volatility interest cover (CVIC), which stood at 2.3x in FY2016 compared to a Moody's-rated peer median of 1.7x in FY2015. The CVIC ratio will remain strong at levels averaging 2.1x over the next five years despite anticipated growth in market sales activities.

SOLID LIQUIDITY POSITION UNDERPINNED BY AMPLE UNENCUMBERED ASSETS

Sovereign's unencumbered assets position, an important measure of long-term financial flexibility, is strong with an estimated value of over GBP1 billion for the merged entity as of November 2016. Liquidity coverage, a forward-looking measure of the ability of immediately available liquidity to cover the next two years of cash need, is expected to be 1.4x (as of November 2016).

Both Sovereign and Spectrum display solid financial management practices, adhering to "Financial Standards" which guide risk appetite which are expected to continue under the newly merged entity. The financial standards set limits for key ratios including net debt to turnover, net debt to assets, and exposure to market sales. The standards also dictate minimum levels for operating margin and social housing letting interest cover. The shared approach towards risk appetite underpinned the merger process and provides a solid decision-making framework going forward.

STRONG REGULATORY FRAMEWORK

The sector's credit quality will continue to benefit from the strong regulatory framework and oversight by the Homes and Communities Agency (HCA). The HCA maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and undertaking In-Depth Assessments of entities where deemed necessary. Additionally, the HCA has powers to make board member and manager appointments where there has been a breach of Regulatory Standards. From October 2017, the HCA will charge fees for social housing regulation, as a means of enhancing the independence and maintaining the effectiveness of the regulator.

RISING, BUT MODERATE, MARKET SALES EXPOSURE IN THE BUSINESS PLAN

After achieving its goal early of reaching 50,000 units by FY2018, Sovereign remains committed to growth. It forecasts revenue growth averaging 3% per year over the next five years, supported by continued build up of its social housing asset base and a modest increase in sales exposure. The association has a track record of successful development, with net capex averaging 41% of turnover in the last five years and delivery of nearly 1000 units per year. The development programme will remain focused on affordable rented housing and shared ownership, with net capex to revenues of 27% remaining aligned with those of its A1-rated peers. On average of the last five years, first tranche shared ownership sales represented 9% of turnover with minimal exposure to outright sales.

Sovereign's exposure to market sales will increase over the next five years, but remain moderate, peaking at 19% of turnover in FY2020. The market sales exposure will include both first tranche shared ownership (averaging 9% of turnover) and outright sales activity (averaging 7% of turnover). While the contribution from social housing lettings is expected to decrease from 87% of turnover in FY2016 to an average of 76% over the next five years, it will remain well above rated peers median of 66%.

RELATIVELY HIGH LEVEL OF DEBT

Sovereign's debt burden is above the median of its Moody's-rated peers, largely a result of its Large Scale Voluntary Transfer (LSVT) history. At FYE2016, its debt was GBP1.16 billion, which was equivalent to around 4.9x revenues and 54% of assets at cost, compared to a Moody's-rated peer median of 3.4x and 38%, respectively. Despite relatively sizeable capital expenditure (capex), Sovereign's indebtedness remained broadly stable over the last five years, hovering around 5.1x of turnover and 51% of assets, as Sovereign's strong cash generation covered a large portion of its capex.

The merger with Spectrum, whose debt burden is lower, combined with increased revenues, will drive a reduction of debt to revenues to an average of 4.4x over the next five years. The debt of the merged entity is expected to increase gradually from GBP1.63 billion at FYE2017 to GBP1.83 million by FYE2021.

As part of the new financial reporting framework, housing associations in the UK were required to report FRS102-compliant accounts from March 2016, including comparatives for March 2015. Categories of the accounts which are most impacted include: housing assets, social housing grant, pensions, and financial instruments. Housing assets may be valued at cost or valuation as under the previous framework, or at deemed cost, which is a revaluation of housing assets at the date of transition. Social housing grant is no longer deducted from the cost of housing assets, but rather recognised as a long-term creditor and amortised. Moody's will continue to adjust gearing to exclude the revaluation reserve, whether an HA values its assets at deemed cost or valuation. Sovereign has adopted deemed cost for its housing assets, without substantial impact on the balance sheet valuation of its assets and the revised treatment had limited impact (<5%) on its gearing ratio.

Refinancing risk was relatively modest at FYE2016 as 88% of the merged entity's outstanding debt was due after five years. Sovereign's bond issuances of GBP175 million in FY2010 and GBP250 million in FY2013 are repayable in 2039 and 2043, respectively. Spectrum's bank facilities of approximately GBP465 million will be brought into the merged group. Spectrum had no capital market funding. The merged entity's exposure to interest rate risk was limited as 75% of its debt is at fixed rates. The association targets fixed-rate debt between 60% and 100% of total debt.

Management makes use of standalone interest-rate swaps for hedging (notional amount of GBP357 million), which introduces the risk of margin calls and consequent collateral posting. As at September 2016, the stand-alone swap contracts had a negative mark-to-market value of GBP138 million. The resulting margin call of GBP116 million (net of thresholds) was met by property and cash collateral.

SOME COMPLEXITY IN GROUP STRUCTURE INCLUDING JOINT VENTURES

The newly merged entity will retain a relatively complex group structure, as guidance from independent advisors was to maintain Spectrum's subsidiaries within the new group, with amalgamation taking place over several years.

The merged group will have some duplicate subsidiaries, including two funding vehicles, two entities providing building services and several subsidiaries focused on development of new homes. Spectrum Property Care, Spectrum's established and successful maintenance company, will remain under the new group structure. The group also contains several joint ventures. The two parent entities merged into a new Registered Provider which retained the Sovereign name. Management plans to rationalise the group structure once Spectrum activities are fully integrated.

OPERATING ENVIRONMENT REMAINS CHALLENGING BUT POLICY IS MORE STABLE

Moody's does not expect additional material adverse policy shifts for the sector and considers the operating environment to be stable in the medium term. Adverse policies announced in the last few years will continue to negatively impact revenues, especially the effects of the 1% annual decrease in social rents (until FY2020) and Universal Credit (a pillar of broader welfare reform measures). However, HAs have demonstrated resilience to adverse policies to date and been proactive to mitigate the impact. A reduction of capital grant for new social housing over the last five years has led to increased exposure to market sales activity, which has more than doubled since 2012 to reach 17% of turnover for Moody's rated HAs in FY2016. Credit risk association with exposure to market sales is incorporated in BCAs.

### Extraordinary Support Considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers of redress available to the regulator in cases of financial distress, with the possibility of a facilitated merger or a transfer of engagements. Recent history has shown that the UK government (Aa2 stable) is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support assumption also factors increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of 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 (HA) and the UK government reflects their strong financial and operational linkages.

## Rating Methodologies

European Social Housing Providers, July 2016 (190944)

Government-Related Issuers, August 2017 (1047378)

## Ratings

Exhibit 3

| 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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