

## CREDIT OPINION

24 November 2016

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### RATINGS

#### Sovereign Housing Association

Domicile	United Kingdom
Long Term Rating	A1
Type	LT Issuer Rating - Fgn Curr
Outlook	Negative

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 to Key Credit Factors

#### Summary Rating Rationale

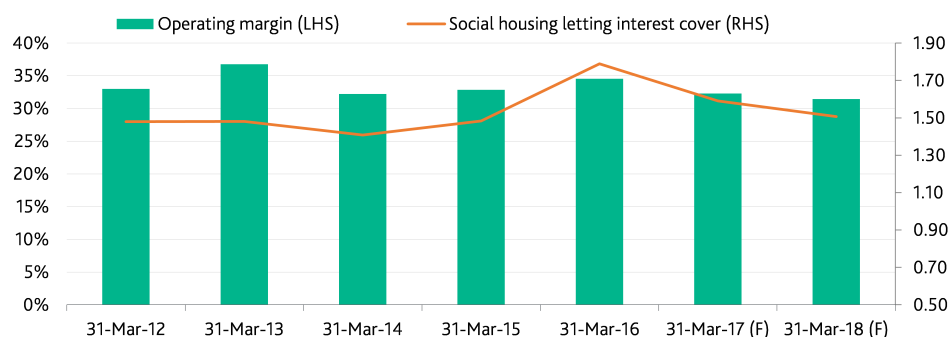
The A1 issuer rating assigned to Sovereign Housing Association (Sovereign) reflects its (1) strong operating margins (2) stable cash flows supporting solid interest cover ratios, (2) strong management practices including adherence to internal “financial standards”; and (3) solid liquidity position supported 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 A1 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 (Aa1 negative) 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 Aa3 to Baa1. 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
- » Government policy changes making the operating environment less predictable and more challenging for housing associations

## Rating Outlook

The negative outlook on Sovereign's rating reflects the sector-wide negative impact of the vote to leave the European Union on housing associations as well as the negative outlook on the Sovereign's rating, reflecting the close institutional, operational and financial linkages between the central government and housing associations.

## Factors that Could Lead to an Upgrade

Moody's believes that upward ratings pressure on the HAs affected by the UK Sub-Sovereign Brexit action is unlikely to develop in view of the challenging operating environment and weakened Sovereign credit conditions. Strengthening credit metrics of stand-alone credit profiles, however, could put upward pressure on Sovereign's rating.

One or a combination of the following could have positive rating implications: (1) reduction in gearing (debt to assets); (2) reduction in market sales activity; (3) overcoming merger execution risks.

## Factors that Could Lead to a Downgrade

Downward ratings pressure would be exerted by further deterioration of the UK Sovereign's credit worthiness. Additionally, whilst unlikely in the near term, negative pressure could be exerted on the rating by one or a combination of the following: following (1) material scaling up of the development programme leading to increased debt, (2) weakening of historically strong interest cover ratios; or (3) deterioration in its adequate liquidity and strong unencumbered assets position. In addition, a 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.

## Recent Developments

In August 2016, Moody's assessed the likely credit impact of Sovereign's intention to merge with Spectrum Housing Group and affirmed the A1 rating. The affirmation reflected Moody's expectation that the credit strength of Sovereign would be maintained following the merger, which completed in November 2016. The organisations share a similar geography, culture and risk appetite which provides a solid foundation for realising efficiencies. This report reflects pre-merger historical numbers and merged entity forecasts.

Additionally, on June 23rd 2016, the UK voted to leave the European Union (EU) in a referendum and on 24 June 2016, a negative outlook was placed on the UK's Aa1 Sovereign's rating. We expect protracted trade negotiations, resulting in a high level of uncertainty in the medium term which will manifest in slower economic growth. On 29 June 2016, the outlook on Sovereign's A1 rating was changed to negative from stable reflecting the potential impact of the vote to leave the European Union on associations. Housing associations (HAs) could be affected by renewed pressure on public finances resulting in further policies that would squeeze HA revenues and any further social housing policy changes exacerbating the policy instability that currently underpins our negative

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outlook on the sector. In addition, the potential loss of EU funding as well as volatility in the UK housing market could constrain the creditworthiness of the sector. The outlook changes also reflect the change in the outlook of the Sovereign's rating to negative from stable, reflecting the close operational linkages between the central government and HAs.

## 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

English housing associations operate in a highly regulated environment, with a strong oversight exercised by the sector's regulator, the Homes and Communities Agency (HCA). The Regulator is responsible for protecting the public investment in social housing and compliance with broad economic and consumer standards. Compliance with the standards is proactively monitored by the HCA through quarterly returns, long term business plan and annual reviews, and focuses on: governance, financial viability, value for money and rents. The HCA's levers of control are wide ranging and include the ability to award capital grant funding, levy financial penalties, and impose independent inquiries or appoint new managers and officers in extreme circumstances. The HCA emphasizes that their role is a co-regulatory one with the primary onus being on boards and executive teams to ensure compliance with the standards.

As part of the Housing and Planning Act 2016, the Regulator's powers are expected to weaken in several areas including: removal of the consent to dispose of housing assets, removal of constitutional consents for group restructuring including mergers, and stricter conditions for appointing officers. The dilution of regulatory oversight and power is credit negative, although we still expect the Regulator to take an active role in managing risk in the sector.

#### 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 billion 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.

#### GOVERNMENT POLICY CHANGES MAKING THE OPERATING ENVIRONMENT LESS PREDICTABLE AND MORE CHALLENGING FOR HOUSING ASSOCIATIONS

The operating environment for social housing providers is fundamentally shaped by government policy and recent budget announcements have made this environment more challenging. On 8 July 2015, the UK government announced (1) a change in the social housing rent formula to 1% annual reduction starting from April 2016 for 4 years (previously growth annually by CPI+1%) and (2) further reductions in the accessibility of certain welfare benefits. The effect of these measures is further magnified by the ongoing implementation of Universal Credit and the likely extension of Right to Buy for HA tenants. Overall, these policy shifts are gradually eroding the ties to the government (which we view as credit positive), by creating a more unpredictable operating environment and undermining the extent and stability of housing benefit's contribution to revenues.

Our preliminary assessment indicates that the change in the rent formula will result in an average annual loss in total turnover of 7% for our rated portfolio over the four years starting FY2017. It is also likely to cause a decline in a currently high proportion of housing associations' turnover coming from social housing rents (median of 81% in FY2016).

Housing benefit paid to working age tenants, who are being affected by the implementation of Universal Credit, represents an estimated 28% of Sovereign's total income, compared to the latest average of 29% for Moody's-rated peers. Sovereign's put in place a range of mitigating measures to respond to Welfare Reform, including (1) proactive management of rent arrears; (2) support for

tenants; and (3) promotion of direct debit payments. The possible extension of the Right to Buy to housing association tenants may lead to positive cash inflows in the short-term, but creates a risk of a longer term erosion of social housing stock.

### 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 (Aa1 negative) is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support also factors housing associations' increasing exposure to non-core social housing activities, that add complexity to their operations and make an extraordinary intervention more challenging.

In addition, our assessment that there is a very high default dependence between Sovereign's and the UK government reflects their strong financial and operational linkages.

### Rating Methodologies

[European Social Housing Providers](#), July 2016 (190944)

[Government-Related Issuers](#), October 2014 (173845)

## Ratings

Exhibit 3

Category	Moody's Rating
<b>SOVEREIGN HOUSING ASSOCIATION</b>	
Outlook	Negative
Issuer Rating	A1
<b>SOVEREIGN HOUSING CAPITAL, PLC</b>	
Outlook	Negative
Senior Secured -Dom Curr	A1

Source: Moody's Investors Service

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