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PUBLIC SECTOR EUROPE

CREDIT OPINION
24 October 2018

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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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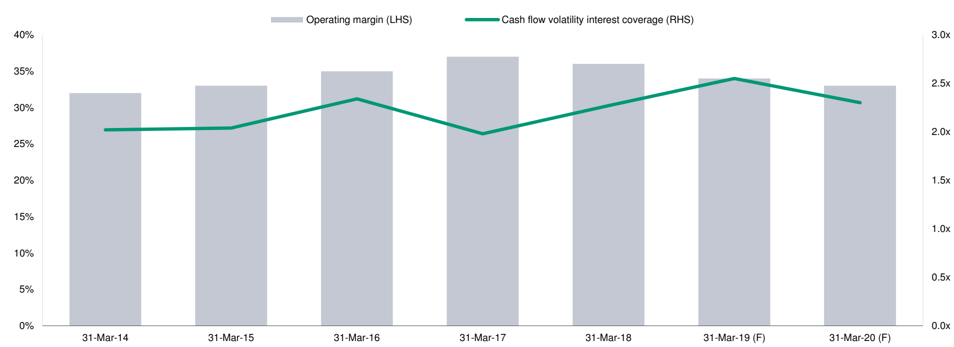
Sovereign Housing Association (the United Kingdom)

Update to credit analysis

Summary

The credit profile of the Sovereign Housing Association (A2 stable) (Sovereign) reflects its strong operating margin; stable cash flow, supporting solid interest cover ratios; high stock of unencumbered assets; and weak liquidity coverage ratio. The rating also takes into account Sovereign's moderately higher debt level and increasing, but moderate, exposure to market sales. 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 2014-20



Sources: Moody's Investors Service, Sovereign

Credit strengths

» Large regional housing association, with strong profitability

» Stable cash flow, supporting strong interest cover ratios

» Strong regulatory framework

Credit challenges

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

» Relatively high level of debt, supported by the high stock of unencumbered assets

» Challenging operating environment, but policy is more stable

Rating outlook

The stable outlook on Sovereign's rating reflects the currently stable operating environment for HAs, which is unlikely to undergo a further material change in the medium term, and the stable outlook on the UK's sovereign rating.

Factors that could lead to an upgrade

Upward pressure on Sovereign's rating could result from reduced and sustained gearing levels below 40% and a debt-to-revenue ratio below 3.5x, as well as improved liquidity coverage 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 further deterioration in the UK government's creditworthiness would strain Sovereign's rating further.

Key indicators

Exhibit 2

Sovereign Housing Association	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19*	31-Mar-20*
Units under management (no.)	35,814	36,188	36,620	56,235	56,782	57,240	58,718
Operating margin, before interest (%)	32.2	32.8	35.1	36.6	36.3	33.8	33.4
Net capital expenditure as % turnover	22.8	41.7	24.8	33.0	17.8	25.2	46.0
Social housing letting interest coverage (x times)	1.4	1.5	1.8	1.8	2.1	1.8	1.5
Cash flow volatility interest coverage (x times)	2.0	2.0	2.3	2.0	2.3	2.5	2.3
Debt to revenues (x times)	4.9	5.1	5.0	4.3	4.2	4.2	4.4
Debt to assets at cost (%)	50.2	54.2	53.7	52.0	49.5	51.0	52.3

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 57,000 units owned and managed as of the end of fiscal 2018, concentrated in South West England.

Sovereign has made substantial progress on efficiencies as outlined in its merger plans, with a very strong operating margin of 36% in fiscal 2018 (37% in fiscal 2017). Savings were mainly made in management and maintenance costs. As a result, the cost per unit fell to £2,860 from £3,420 over the past two years. In fiscal 2018, additional efficiency savings of £5 million were delivered, making a total of £26 million in savings since fiscal 2016 (out of the planned £34 million), with the remaining expected to be delivered over the next few years. Efficiency savings include £24 million of pre-merger planned savings for the individual entities, in addition to £10 million of merger savings.

Sovereign's operating margin of 36% in fiscal 2018 was above the A2-rated peer median of 30% in the same 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.

Stable cash flow, supporting strong interest cover ratios

Strong operating performance translates into solid interest cover ratios. Sovereign's SHLIC, which measures the cover of interest payments from social housing letting revenue, reached 2.1x in fiscal 2018, slightly above the A2-rated peer median of 1.9x. However, as the association plans to focus more on nonsocial housing letting activities and take on additional debt, its SHLIC is expected to weaken, averaging 1.6x over the next three years.

Despite its growing market sales programme, Sovereign's operating cash flow is expected to remain relatively stable. Its cash flow volatility interest cover strengthened in fiscal 2018 to 2.3x from 2.0x in fiscal 2017 and is expected to remain above the A2-rated peer median of 2.2x (fiscal 2018) over the next three years, peaking at 2.6x in fiscal 2019.

Strong regulatory framework

The sector's credit quality will continue to benefit from the strong regulatory framework and oversight by the Regulator of Social Housing. The regulator maintains strong oversight through quarterly returns, long-term business plans and annual reviews, and by undertaking in-depth assessments of entities where deemed necessary. Additionally, the regulator has powers to make board member and manager appointments where there has been a breach of regulatory standards.

Rising, but moderate, market sales exposure in its business plan

Sovereign remains committed to growth, with a development programme of around 1,725 homes per year over the next three years. The development programme incorporates several tenures including social rent, shared ownership and outright sales (both through Sovereign and through joint ventures). New units coming online will support steady revenue growth, averaging 9% per year over the next three years, reaching £494 million by fiscal 2021, up from £378 million in fiscal 2018.

Sovereign's exposure to market sales will increase gradually over the next three years, reaching 28% of turnover by fiscal 2020, up from 14% in fiscal 2018. Although the business plan incorporates an increase in market sales activity, Sovereign's financial standards limit the amount of exposure to 30% of turnover (up from 25% during the year). The market sales exposure will include both first-tranche shared ownership (averaging 15% of turnover) and outright sales activity (averaging 8% of turnover). Assumptions for profitability on market sales are attainable, averaging 15% over the next three years compared with 20% in fiscal 2018.

Relatively high level of debt, supported by its high stock of unencumbered assets

Sovereign's debt burden is above the median of its rated peers, mostly a result of its large-scale voluntary transfer history. As of fiscal 2018, Sovereign's debt of £1.6 billion was equivalent to 4.2x revenue and 50% of assets at cost, compared with the A2-rated peer medians of 3.5x and 41%, respectively. Debt will increase gradually to £2 billion by fiscal 2021 to fund growth, but reserves and revenue will also increase, resulting in stable debt metrics. The debt-to-revenue ratio will average 4.2x and gearing (the ratio of debt-to-assets at cost) will average at 52% over the next three years.

Management uses standalone interest rate swaps for hedging (notional amount of £357 million), including some inflation and LIBOR linked swaps, which introduces the risk of margin calls and consequent collateral posting. As of July 2018, the standalone swap contracts had a negative mark-to-market value of £81 million. The resulting margin call of £57 million (net of thresholds) was primarily met by property collateral.

Sovereign has 18% of its debt due within the next five years. New facilities totaling £305 million were arranged in fiscal 2017 with the European Investment Bank (EIB) and Affordable Housing Finance (AHF). The AHF facilities have already been drawn and £45 million of the total £150 million EIB facilities available have been drawn, leaving £105 million scheduled to be drawn by December 2019. Along with the EIB funds, Sovereign has three more facilities in place, making a total of £245 million non-immediately available funds to be drawn in addition to its £156 million of immediately available funding. Sovereign has a modest exposure to interest rate risk, with 15% of its debt held at variable rates.

Sovereign's unencumbered asset position, a measure of its long-term borrowing capacity, is strong, with an estimated value of £1.1 billion at EUV-SH (Existing Use Value for Social Housing) as of August 2018. The current unencumbered asset position is well in excess of its three-year forecast for net new borrowing of £381 million.

Operating environment remains challenging, but policy more stable

We do not expect additional material adverse policy shifts for the sector and consider the operating environment stable in the medium term. Adverse policies announced in the last few years will continue to hurt revenue, especially the effects of the 1% annual decrease in social rents (until fiscal 2020) and Universal Credit (a pillar of broader welfare reform measures). However, HAs have demonstrated resilience to adverse policies to date and have been proactive in mitigating the impact. A reduction in 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, reaching 31% of turnover for rated HAs in fiscal 2017. Credit risk associated with the exposure to market sales is incorporated in the BCA.

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 3

Sovereign Housing Association			
Baseline Credit Assessment	**Sub-factor Weighting**	**Value**	**Score**
Scorecard			
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	56,782	a
Factor 3: Financial Performance			
Operating Margin	5%	36.3%	aa
Social Housing Letting Interest Coverage	10%	2.1x	aa
Cash-Flow Volatility Interest Coverage	10%	2.3x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.2x	ba
Debt to Assets	10%	49.5%	ba
Liquidity Coverage	10%	0.6x	baa
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 4

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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