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Research Update:

U.K.-Based Sovereign Housing Association Outlook To Negative On Increasing Market Exposure; Rating Affirmed

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Overview

- Sovereign Housing Group (Sovereign) has committed to increase its development program over the next few years and increase its exposure to market-related activities, which carry higher risks than traditional social housing activities and increase the volatility of the business, in our view.
- That said, its large asset base of social housing units leads us to expect Sovereign to maintain robust profitability and solid debt and interest coverage based on its social housing activities over the next two to three years.
- We are affirming our 'A+' rating on Sovereign.
- We are revising the outlook to negative, mirroring the outlook on the U.K. sovereign rating. We would lower the ratings if Sovereign's increased exposure to sales risk caused its creditworthiness to weaken over the next 24 months.

Rating Action

On Oct. 24, 2018, S&P Global Ratings revised to negative from stable its outlook on U.K.-based social housing provider Sovereign Housing Association Ltd. (Sovereign). At the same time, we affirmed our 'A+' long-term issuer credit rating on Sovereign.

We also affirmed our 'A+' long-term issue ratings on Sovereign Housing Capital PLC's £175 million and £250 million senior secured bonds. Sovereign Housing Capital is a special-purpose financing vehicle set up for the sole purpose of issuing bonds and lending the proceeds to Sovereign, and we view it as a core subsidiary of the Sovereign Housing Group.

Rationale

The outlook revision reflects our view that Sovereign is more likely to increase its exposure to sales activities over the next three years as part of its development program than we thought at our previous ratings review. More of its revenues are coming from market-related activities, reflecting a broader sectorwide shift. This includes more outright sales and first-tranche sales (FTS) of shared-ownership properties. Sovereign has seen strong appetite

for its sales activities in some of its operations areas, particularly shared ownership and the Bristol region. However, these activities expose the housing association to the cyclical nature of the residential property development sector and generates potentially more volatile revenues. Thus, it reduces the visibility and predictability of future earnings compared with a traditional social housing association providing mainly social rent properties. We also consider that Brexit increases the risk for housing associations that plan to derive revenue from sales activities. We forecast that the economy will shrink and house price growth slow, heightening revenue and earnings volatility. Ultimately, demand for properties for sale is not only based on interest rates and the availability of mortgage loans but also on consumer confidence, disposable income, employment levels, and economic growth. As a result, we have revised down our assessment of Sovereign's stand-alone credit profile (SACP) to 'a' from 'a+' and our outlook on Sovereign to negative.

That said, we still see a moderately high likelihood that Sovereign would receive support from the U.K. government in case of financial distress. Our rating on Sovereign therefore benefits from one notch of uplift on the SACP, leading us to affirm it at 'A+'. We base our view of the likelihood of extraordinary government support on our assessment of Sovereign's important role for the U.K. government, its public policy mandate, and its strong link with the U.K. government, which has a track record of providing extraordinary support within the sector.

The ratings affirmation also reflects our base-case expectation that Sovereign will continue posting robust profitability thanks to its large asset base of social housing units (more than 55,000 units, since its merger with Spectrum Housing Group), as well as solid debt and interest coverage from the social housing activities over the next three years. We anticipate that Sovereign will achieve further savings in our forecast period and deliver about 1,500 new homes per year on average (excluding development through joint ventures), substantially higher than 1,200 new homes completed in 2017/2018, which already made Sovereign as one of the largest U.K. social housing developers. We also expect Sovereign to limit exposure to sales activities to less than one-third of its revenue over the coming years; as a result, we still view it as a social housing provider that is exposed to low industry risk.

Our assessment of Sovereign's SACP reflects the group's strong enterprise profile, supported by its very strong asset quality and operational performance, as illustrated by the very low vacancy level, which stood at just 1% of net rental income over the financial year (FY) ending in March 2018. We also expect Sovereign to control the negative impact of welfare reforms and the roll out of Universal Credit by keeping current arrears below 6% of net rental income over the next few years. Nevertheless, despite strong demand for social housing in Sovereign's areas of operations in southwest England, we have revised our assessment of economic fundamentals down, in light of the group's plan to increase its exposure to nontraditional activities, chiefly sales activities (FTS and outright sales). Under our revised base case, we assume these activities will comprise nearly 22% of Sovereign's total turnover by 2020/2021, up from 14% in 2017/2018.

Despite changes at the top executive level this year, we consider that Sovereign has maintained sufficient expertise to manage its significant development program, even faced with various reforms and Brexit. We also factor in our base case Sovereign management's ability to limit risks stemming from higher exposure to sales activity to 30% of its total turnover over the coming years, and to maintain solid profitability and control debt levels, after it fully consolidated its merger with Spectrum Housing Group (Spectrum), which concluded two years ago.

Our rating on Sovereign is supported by our view that the group's financial profile will remain strong in our updated 2019-2021 base case. In 2017/2018, Sovereign fully consolidated its merger with Spectrum and posted an adjusted EBITDA margin of 43%, fully in line with our last base case and with the already very solid financial performance recorded in 2016/2017. It achieved further savings and reduced its cost per unit.

Given that our base case anticipated rising exposure to lower-margin sales activities, we anticipate that adjusted EBITDA margins will gradually fall to below 40% in 2021. We forecast that profitability from lettings activity will remain sound, supported by the new rent regime to be implemented from 2021 onward. Therefore, we expect Sovereign to absorb the additional debt needed to finance the development plan and maintain moderate debt levels compared with peers at just 11x--this is in line with our former base case. Adjusted EBITDA interest coverage will continue to stand at above 2x over our forecast horizon and we anticipate that the coverage ratio, based on social housing lettings alone, will also remain higher than that of U.K. peers.

Liquidity

We continue to view Sovereign's liquidity position as strong. We expect sources of liquidity for the group to exceed planned uses by 1.5x over the next 12 months, but be lower than the 1.7x anticipated in our last base case due to the forecasted ramp up in the development plan. The still-solid coverage incorporates about £275 million of committed and secured undrawn bank facilities, about £160 million of cash flow from operations (before interest payments), £36 million of cash, and about £15 million of proceeds from asset sales.

This high level of liquid assets is set to be used to finance Sovereign's large capital development program, with more than £200 million of capital expenditure and close to £110 million of debt principal and interest payment anticipated in our base case for the next 12 months. Our opinion of Sovereign's strong liquidity position is also supported by £90 million of undrawn but unsecured bank facilities held by the group at present.

We view Sovereign's access to external liquidity as satisfactory, given its ready access to bank funding, but limited track record of issuance on the capital markets.

Outlook

The negative outlook reflects our view that increased exposure to sales risk could cause Sovereign's creditworthiness to weaken in the next 24 months, in particular in the context of Brexit, which will weigh on the macroeconomic environment and on house prices.

Downside scenario

We could lower the ratings if Sovereign became structurally heavily reliant on nontraditional activities, that is, revenue from sales accounting for more than 30% of its turnover. This would breach the limit fixed by Sovereign management in its latest business plan presented in mid-2018. This could erode its ability to withstand market fluctuations by increasing exposure to cyclical first-tranche sales, which would increase operating surplus volatility and put pressure on operating margins and group liquidity. Given that our rating on Sovereign benefits from a one-notch uplift as a result of government support, if we were to lower our ratings on the U.K., we would downgrade Sovereign.

Upside scenario

We could revise the outlook to stable in the next 24 months if we took a similar action on the U.K. sovereign ratings and if Sovereign proves able to maintain strong financials without additional exposure to market-related activities compared with our baseline scenario.

Table 1

Sovereign Housing Association Ltd. Selected Financial Indicators					
	--Year ended March 31--				
(Mil. £)	2017a	2018e	2019bc	2020bc	2021bc
Number of units owned or managed	56,235	56,782	58,152	59,582	61,026
Vacancy rates (% of rent net of identifiable service charge)	1.3	1.2	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	3.8	3.1	N.A.	N.A.	N.A.
Revenue§	369.0	375.6	397.6	405.1	438.4
Share of revenue from nontraditional activities (%)	20.1	22.9	26.4	26.4	28.2
EBITDA†	159.1	161.7	159.6	157.8	171.7
EBITDA/revenue (%)	43.1	43.0	40.1	39.0	39.2
Interest expense	67.3	62.5	70.6	76.0	84.0
Debt/EBITDA (x)	10.2	9.9	10.5	11.8	11.4
EBITDA/interest coverage‡ (x)	2.4	2.6	2.3	2.1	2.0
Capital expense‡	203.7	162.2	202.0	263.2	259.4
Debt	1,616.1	1,599.3	1,668.6	1,860.7	1,955.1

Table 1

Sovereign Housing Association Ltd. Selected Financial Indicators (cont.)					
--Year ended March 31--					
(Mil. £)	2017a	2018e	2019bc	2020bc	2021bc
Housing properties (according to balance sheet valuation)	3,416.2	3,520.3	3,684.4	3,909.7	4,131.2
Loan to value of properties (%)	47.3	45.4	45.3	47.6	47.3
Cash and liquid assets	45.2	26.2	20.0	69.4	32.8

*Rent and service charge arrears. §Adjusted for grant amortization. †Adjusted for capitalized repairs. ‡Including capitalized interest. a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Ratings Score Snapshot

Table 2

Sovereign Housing Association Ltd. Rating Score Snapshot	
Industry Risk	2
Economic fundamentals and market dependencies	4
Strategy and management	2
Asset quality and operational performance	1
Enterprise profile	3
Financial performance	4
Debt profile	3
Liquidity	3
Financial policies	2
Financial profile	3

S&P Global Ratings bases its ratings on nonprofit social housing providers on the eight main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published on Dec. 17, 2014, summarizes how the eight factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating. For social housing providers generating more than a third of its consolidated revenues from open market sales, we also refer to the "Key Credit Factors For The Homebuilder And Real Estate Developer Industry."

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Governments - General: Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action	To	From
Sovereign Housing Association Ltd. Issuer Credit Rating	A+/Negative/--	A+/Stable/--
Ratings Affirmed		
Sovereign Housing Capital PLC Senior Secured	A+	

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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