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Research Update:

U.K.-Based Sovereign Housing Association Rating Lowered To 'A+' On Weakening Financial Profile; Outlook Stable

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Overview

- We have revised our assessment of Sovereign Housing Association's (Sovereign) financial profile to strong from very strong. This reflects our view that Sovereign's S&P Global Ratings-adjusted EBITDA margins and liquidity position will weaken in 2017-2019 due to revenue pressure stemming from rent cuts, while the group also has an ambitious development program.
- We are therefore lowering our long-term issuer credit rating on Sovereign by one notch to 'A+' from 'AA-'.
- The stable outlook reflects our view that Sovereign will continue to exhibit a very strong enterprise profile with limited exposure to market risks and a strong financial profile in the context of its upcoming merger with Spectrum Housing Group in fourth-quarter 2016.

Rating Action

On Oct. 4, 2016, S&P Global Ratings lowered its long-term issuer credit rating on U.K.-based social housing provider Sovereign Housing Association (Sovereign) to 'A+' from 'AA-'. The outlook is stable.

At the same time, we lowered our long-term issue ratings on Sovereign Housing Capital PLC's £175 million and £250 million senior secured bonds to 'A+' from 'AA-'. Sovereign Housing Capital PLC 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 downgrade reflects our view that Sovereign's financial profile will structurally deteriorate over the next few years, reflecting weaker adjusted EBITDA margins as well as a reduced liquidity position. The current financial year (FY) marks the beginning of rent cuts resulting from the U.K. central government welfare reforms, which will weigh on Sovereign's financial profile. At the same time, the group has an ambitious capital program that will require additional funding over the next few years.

We understand that Sovereign will likely merge with Spectrum Housing Group by the end of 2016. The combined group will own and manage about 55,000 properties across the southwest of England and will aim to develop about 13,000 new homes by fiscal year 2025. We expect the group to retain its strong traditional social housing focus, aiming to keep exposure to riskier market activities to below 20% of total annual turnover. Our 2017-2019 base-case scenario financial forecasts continue to solely reflect Sovereign as a stand-alone entity.

The 'A+' rating on Sovereign Housing Association, the parent of the entities forming the Sovereign Housing Group, is based on its stand-alone credit profile (SACP), which we assess at 'a+'. We also continue to acknowledge that the moderately high likelihood of Sovereign receiving extraordinary support from the U.K. government, working through the Homes and Communities Agency, has a neutral effect on the ratings.

In accordance with our criteria for government-related entities, we base our view of the likelihood of extraordinary government support on our assessment of Sovereign's important role for the U.K. government and its public-policy mandate, and its strong link with the government. The U.K. government has a track record of providing extraordinary support to the sector in case of distress.

Our assessment of Sovereign's SACP reflects the group's very strong enterprise profile, supported by our view of the low industry risk for social housing and Sovereign's very strong asset quality and operating performance. It is also underpinned by the strong demand for social housing in Sovereign's areas of operations, despite lower economic fundamentals than peers operating in the London area when comparing evolution of social rents to market rents in the southwest of England. The group has maintained very low voids and arrears, averaging about 0.8% and 2.2% over the past three years (FY2014-2016), respectively, despite the ongoing pressure on tenants stemming from government-imposed welfare reform. In this regard, we view management as strong, and we take into account its experience, consistency in strategic direction, and conservatism with regard to exposure to risky market-related activities. Sovereign’s continued focus on traditional social housing activities is also apparent in its ambitious development program to build more than 9,200 homes by fiscal year 2025, the vast majority of which will be affordable and less risky shared-ownership.

In our 2016 updated base-case scenario, we view Sovereign’s financial profile as strong, whereas we viewed it as very strong previously. Despite management’s strong and ongoing track record of controlling costs, we believe the pressure on revenue stemming from rent cuts will take its toll on the group’s financial performance over our forecast horizon. This reflects the group’s predominant focus on traditional social housing lettings (86% of total turnover in fiscal 2016). Fiscal year 2017 is the first of a four-year period during which social housing associations will feel the effect of the new rental framework of CPI-1% (through to fiscal year 2020), compared to the previous CPI+1%, which the government introduced as part of its welfare reform .

In response to the rent cuts, Sovereign has embarked on a cost-saving program that aims to achieve £16 million in savings by fiscal 2019. However, this will not compensate for losses resulting from rent cuts. In addition, we note that forecast margin levels depend somewhat on sales proceeds from shared-ownership (accounting for 11% of Sovereign's turnover in our 2018-2019 base-case scenario) as well as right-to-buy scheme sales. Although these are less risky than open-market sales, they still subject Sovereign's margins to uncertainty. Therefore, we forecast adjusted EBITDA margins to gradually go below 40%, falling to 38% in FY2019.

Owing to still sound EBITDA margins, we expect Sovereign's debt level to rise at a relatively moderate pace, from about 12.4x of adjusted EBITDA in fiscal 2016 to about 13.2x in fiscal 2019. Adjusted EBITDA interest coverage will remain high at about 1.9x on average over our forecast horizon. We continue to factor into our debt assessment Sovereign's high level of unencumbered assets, representing about 65% of total debt as of September 2016. This would mitigate any refinancing risk, were such risk to arise over the rating horizon.

Liquidity

We assess Sovereign's liquidity position as strong. We expect sources of liquidity to exceed planned uses by about 1.6x over the next 12 months. The strong coverage incorporates £73 million of committed undrawn bank facilities and £120 million of cash as of September 2016. Cash has increased from the reported level at the end of fiscal 2016 (by about £50 million), as Sovereign drew about £67 million from the available £100 million Affordable Housing Finance facility contracted in July 2016. However, this high level of liquid assets is set to be used to co-finance Sovereign's capital development program.

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 stable outlook reflects our view that Sovereign will continue to exhibit a very strong enterprise profile with limited exposure to market risks and a strong financial profile in the context of its upcoming merger with Spectrum Housing Group. Given the preliminary consolidation exercise we have performed, based on current available information, we believe that the coming merger will most likely have a neutral impact on the ratings.

Although unlikely at this stage (given the planned merger), we could lower the ratings on Sovereign if we observed further deterioration in its financial performance with adjusted EBITDA margins falling below 30% owing to weakening cost control or an inability to meet revenue targets from shared ownership. Under such a scenario, we would likely observe a worsening of the liquidity position and rising debt levels, which would prompt us to revise down our assessment of Sovereign's financial profile.

Conversely, we could raise the ratings over the next 24 months if we observed, either on a stand-alone basis or at the future merged entity, an improving financial performance. This would be characterized by adjusted EBITDA margins structurally above 40%, as well as a stronger liquidity position than we current assess in our base-case scenario.

Sovereign Housing Association Ltd. Selected Financial Indicators

('000. £)	2015a	2016a	2017bc	2018bc	2019bc
Number of units	36,188	36,375	37,173	37,923	38,773
Vacancy rates (% of net rental income)	0.74	0.73	1.00	1.00	1.00
Arrears (% of net rental income)*	2.0	1.7	-	-	-
Revenue	223,532	234,724	237,862	247,061	254,323
Share of revenue from non-traditional activities (%)	13.3	13.1	-	-	-
Operating expense	150,104	153,621	150,009	160,617	167,787
EBITDA§	86,516	94,578	100,307	95,892	96,763
EBITDA/revenue (%)	38.7	40.3	42.2	38.8	38.0
Interest expense	47,967	47,770	49,530	52,172	52,862
Debt/EBITDA (x)	13.2	12.4	11.7	12.7	13.2
EBITDA/interest coverage (x)†	1.8	2.0	2.0	1.8	1.8
Capital expense	152,156	127,628	97,438	166,062	173,153
Debt	1,141,234	1,169,441	1,172,786	1,219,487	1,279,618
Housing properties (according to balance-sheet valuation)	2,439,540	2,500,756	2,532,616	2,633,784	2,747,470
Loan to value of properties (%)	46.8	46.8	46.3	46.3	46.6
Cash and liquid assets	49,166	49,445	1,648	6,754	1,444

*Current arrears §Adjusted for capitalized repairs. †Including capitalized interest. a--Actual bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Related Criteria And Research

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 - December 17, 2014
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Sovereign Housing Association Long-Term Rating Lowered To 'AA-' Following Downgrade Of United Kingdom; Outlook Stable, July 4, 2016
- Ratings On The United Kingdom Lowered To 'AA' On Brexit Vote; Outlook Remains Negative On Continued Uncertainty, June 27, 2016

Ratings List

	Rating	
	To	From
Sovereign Housing Association Ltd.		
Issuer Credit Rating		
Foreign and Local Currency	A+/Stable/--	AA-/Stable/--
Sovereign Housing Capital PLC		
Senior Secured		
Local Currency[1]	A+	AA-
Local Currency	A+	AA-

[1] Dependent Participant(s): Bank of New York Mellon (London Branch) (The)

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.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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.