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## Research Update:

# U.K.-Based Sovereign Housing Association Rating Affirmed At 'A+'; Outlook Remains Stable

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## Research Update:

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## Overview

- In November 2016, Sovereign Housing Association Ltd. (Sovereign) merged with Spectrum Housing Group to form the sixth-largest housing association in the country, providing over 55,000 homes concentrated in the southwest of England.
- The new amalgamated entity has reported very solid adjusted EBITDA margins at above 40% in in the financial year ending March 2017, in particular thanks to substantial completed savings, and managed to secure more than £300 million of funding to cover its development program throughout 2020.
- We expect Sovereign Housing Group to continue posting sound profitability and moderate debt levels in the next two to three years.
- We are therefore affirming our long-term issuer credit rating on Sovereign at 'A+'.
- The stable outlook reflects our base-case expectation that Sovereign will continue to exhibit a very strong enterprise profile with limited exposure to market risks and show a strong financial profile by continuing to positively manage the amalgamation with Spectrum.

## Rating Action

On Oct. 24, 2017, S&P Global Ratings affirmed its long-term issuer credit rating on U.K.-based social housing provider Sovereign Housing Association Ltd. (Sovereign) at 'A+'. The outlook remains stable.

At the same time, we affirmed our long-term issue ratings on Sovereign Housing Capital PLC's £175 million and £250 million senior secured bonds at 'A+'. 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 ratings affirmation reflects our view that Sovereign's management will continue to show sound profitability and moderate debt levels, despite continued pressure stemming from rent cuts and rising inflation in the U.K. that will drive up costs and stress margins in our base-case scenario. We believe Sovereign will achieve further savings in our forecast period and deliver about 1,400 new homes per year that will likely support the entity's revenue flows. We expect the group to retain its strong traditional social housing focus, aiming to keep exposure to riskier market activities to 20% of total annual turnover throughout 2020, despite some increase in first tranche shared-ownership sales observed in the financial year (FY) ending March 2017. The 'A+' rating on Sovereign, the parent of the entities forming the Sovereign Housing Group, is based on its stand-alone credit profile (SACP), which we continue to assess at 'a+'.

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 operational performance. It is also underpinned by the strong demand for social housing in Sovereign's areas of operation, despite weaker economic fundamentals in the southwest of England compared with peers operating in the London area, in terms of population growth and the evolution of social rents to market rents. We understand that the enlarged Sovereign Housing Group, which now provides more than 55,000 homes concentrated in the southwest of England following the merger with Spectrum Housing Group, has no aspiration to develop its activity in other regions of the country. Despite the weaker operational performance displayed by Spectrum over the past few years, the combined entity has maintained very low voids and arrears, averaging about 1% voids and 2% arrears over FY2015-FY2017.

We view Sovereign's management as strong, and we take into account its experience, consistency in strategic direction (incorporating the merger between Sovereign and Spectrum), 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 close to 15,000 new homes over the next 10 years, the vast majority of which will be affordable housing. Even if we believe Sovereign will step up investments over the next years, we anticipate lower completion of new homes (1,400 new homes per year in our 2018-2020 base case compared to 1,500 homes according to Sovereign's plan) notably because we expect the industry to face some labor shortages in the context of Brexit.

Based on consolidated accounts of the merged entity, Sovereign reported a much higher surplus in FY2017, with an adjusted EBITDA margin of 43% compared to 36% in FY2016. This stems from an increase in first tranche shared-ownership sales but also substantial savings completed over the last year (£22 million or about two-thirds of the group's objective for the 2016-2020 period) and following the merger completion. We expect Sovereign to continue posting a strong financial profile underpinned by sound profitability in our 2018-2020 base case. However, in line with our industry forecast, we think rent cuts and rising inflation in the U.K. will drive up costs and likely stress Sovereign's margins over the next two to three years. We also anticipate that close to 15% of Sovereign's turnover will stem from sales business (mainly first tranche shared-ownership sales), which carries lower profitability and exposes the group to higher volatility than the affordable lettings market, in our view. Therefore, we forecast adjusted EBITDA margins to gradually go below 40% throughout 2020.

Owing to still sound EBITDA margins, we expect Sovereign's debt level to rise at a relatively moderate pace, from about 10x of adjusted EBITDA in FY2017 to about 12x in FY2020. Adjusted EBITDA interest coverage will remain high at about 2x on average over our forecast horizon. Nevertheless, in our updated base case, we believe that unencumbered asset value (on an "existing use value for social housing" basis) will gradually fall below 50% of outstanding debt as Sovereign will charge property

security on its £150 million European Investment Bank (EIB) facility this year and on a future bond issuance we anticipate before 2020.

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.

## **Liquidity**

We view Sovereign's liquidity position as strong. We expect sources of liquidity for the group to exceed planned uses by 1.7x over the next 12 months. The solid coverage incorporates about £270 million of committed undrawn bank facilities, £180 million of cash flow from operations (before interest payments), £45 million of cash, and about £30 million of proceeds from asset sales. The available amount on committed bank facilities increased over the last financial year, as Sovereign was able to raise more than £300 million of new funding facilities from the EIB and Affordable Housing Finance. However, 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 £100 million of debt principal and interest payment anticipated in our base case for the next 12 months.

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 base-case expectation that Sovereign will continue to exhibit a very strong enterprise profile with limited exposure to market risks and show a strong financial profile by continuing to positively manage the amalgamation with Spectrum.

Although unlikely at this stage, we could lower the ratings on Sovereign if we observed a deterioration in its financial performance with adjusted EBITDA margins approaching 30% owing to weakening cost control or an inability to meet revenue targets from market-related activities. 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 Sovereign's financial performance displayed adjusted EBITDA margins structurally above 40% along with still-limited exposure to market sales. An upgrade would also be contingent on a stronger liquidity position.

## Sovereign Housing Association Ltd. Selected Financial Indicators

Year Ended	March 31				
	2016a	2017a	2018bc	2019bc	2020bc
Balance Sheet Date Year					
<b>('000 £)</b>					
Number of units	52,719	53,963	54,601	55,960	57,303
Vacancy rates (% of rent net of identifiable service charge + service and utility charge)	1.30	0.60	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge + service and utility charge)*	1.7	1.9	N.A.	N.A.	N.A.
Revenue§	350.6	369.0	374.1	378.0	383.0
Share of revenue from non-traditional activities (%)	17.8	20.1	20.3	20.5	20.9
Operating expense (before D&A)	208.7	198.0	201.0	205.5	211.0
EBITDA¶	124.6	159.1	160.9	155.7	153.0
EBITDA/revenue (%)	35.5	43.1	43.0	41.2	39.9
Interest expense	61.6	58.9	68.1	70.9	75.3
Debt/EBITDA (x)	12.7	10.2	10.3	11.0	12.0
EBITDA/interest coverage (x)†	2.0	2.7	2.4	2.2	2.0
Capital expense	197.2	216.9	208.4	192.4	220.8
Debt	1,582.1	1,616.1	1,650.6	1,708.5	1,831.9
Housing properties (according to balance sheet valuation)	3,299.1	3,416.2	3,552.7	3,693.9	3,861.8
Loan to value of properties (%)	48.0	47.3	46.5	46.3	47.4
Cash and liquid assets	63.9	45.2	11.3	(7.0)	7.7

\*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.

## 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

- U.K. Social Housing Risk Indicators, June 9, 2017
- Research Update: Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 28, 2017

## Ratings List

*Research Update: U.K.-Based Sovereign Housing Association Rating Affirmed At 'A+'; Outlook Remains Stable*

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

[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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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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