Research Update:

U.K.-Based Housing 21 Affirmed At 'A'; Outlook Stable

July 24, 2020

PRIMARY CREDIT ANALYST

Noa Fux
London
+44 020 7176 0730
noa.fux
@spglobal.com

SECONDARY CONTACT

Christopher Mathews
London
+ 44 20 7176 7115
christopher.mathews
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

Overview

- We anticipate that the profitability of U.K. social housing provider Housing 21 (H21) will remain constrained, primarily due to COVID-19 effects and the group's continued investment in its existing properties.
- That said, in our view, continued strong demand for H21's services, and a higher proportion of revenues from higher-margin rents than we previously assumed, will support a gradual recovery in the group's profitability over the next two-three years.
- We are therefore affirming our 'A' long-term issuer credit rating on H21.
- The stable outlook reflects our view that demand will remain very strong for H21's rental homes and services, supporting low, albeit stable, margins.

Rating Action

On July 24, 2020, S&P Global Ratings affirmed its 'A' long-term issuer credit rating on Housing 21 (H21). The outlook is stable. At the same time, we affirmed our 'A' issue rating on H21's £250 million senior secured bond.

Rationale

The affirmation reflects our view that despite COVID-19 effects delaying a recovery in H21's profitability, demand for the group's rental homes and services will remain high. This is thanks to H21's reputation in the care services segment, underpinned by an ageing population in the U.K. Moreover, we understand that H21 has revised its development program to focus on rental units, which, in our view, will support a gradual improvement in its margins and alleviate the pressure on its debt metrics. We anticipate that H21 will raise additional funding in the financial year ending March 31, 2021 (FY2021) to develop new properties.

As for other registered English housing associations, we believe there is a moderately high likelihood that H21 would receive extraordinary support in case of financial distress. This provides a one-notch uplift from the stand-alone credit profile. H21's primary purpose is to provide affordable homes, supporting important policy objectives of the U.K. government. We consider that the Regulator of Social Housing (RSH), a government agency, regulates H21 to promote a viable, efficient, and well-governed social housing sector, and maintain lender confidence and low funding costs across the sector. It is therefore our view that the RSH would step in to prevent a default in the sector, based on its record of being willing and able to provide extraordinary support on a timely basis.

H21's rating strengths remain primarily strong demand, its risk-averse strategy, and its improving asset quality and operational performance. In our view, H21's focus on tenants aged 65 years old and above results in strong demand for its services. England has a rapidly ageing population, with the Office of National Statistics forecasting annual growth in the number of people over 65 years old of nearly 2% until 2029. In our opinion, this strong growth in H21's target customer base will support demand. Also supporting demand are H21's nationwide presence and low average social housing rents compared to market rents.

Operationally, H21 has continued to work on reducing the level of voids, which has historically been higher than that of its rated peers. Overall, voids stood at 1.7% of H21's total rental income and service charge receivable for FY2020. We believe that this reflects management's efforts to reduce void rates. Nonetheless, we expect that property re-letting over the lockdown period has been slower than usual, implying that voids will stay above 2% in the medium term. H21 continues to record low arrears of 2.4% in FY2020, lower than the average arrears of its rated peers.

Strategically, H21's management has already updated its budget for FY2021 and revised its business plan accordingly. Management has also revised its development plan. It has scaled the plan down, especially in FY2021, to reflect delays in handovers and sales, but also significantly reduced the share of shared-ownership units. Overall, H21 expects to develop around 1,800 units between FY2021 and FY2023. While we continue to see this as an ambitious target as H21 has not achieved developments on this scale in the past three years, we consider it more feasible than the previous target of close to 2,700 units over three years. We expect only limited development of units for outright sale.

We consider H21's governance to be stable, despite recent corrective measures to address issues the RSH identified relating to previous overcharges of the service fee to a number of Extra Care schemes. The group has also pledged to revise rents found to be higher than the allowed rent. We understand that these issues are technical in nature and that H21's management and board are addressing them appropriately. As such, we do not consider them to reflect a weaker governance culture.

We expect that COVID-19 effects and H21's high investments in its existing properties will weigh on its profitability over the coming two years. We anticipate a decline in rental revenues this year due to increasing arrears over the lockdown period, as well as rental losses due to the higher void rate.

At the same time, we understand that H21 has incurred additional costs, mostly related to care activities, which the group is working with local authorities to recover. A further mitigating factor for this year's weak performance is a lower level of capitalized works, as we do not believe that H21 will be able to complete its original program, mostly due to limited access to the properties. However, we expect the program to overrun into next year, which underpins the low margins in FY2022. Overall, we anticipate that H21's S&P Global Ratings-adjusted EBITDA margins will average a modest 18% over the next three years.

We expect that the slow recovery in margins and high capital expenditure (capex) will put pressure on H21's debt metrics. We now expect debt to peak at around £700 million in FY2023. We note the group's prudent policy to ensure it has £100 million of cash and facilities available at all times. This policy is fully integrated into the business plan. To fund its development capex, we expect H21 to secure additional funding in FY2021. As such, we expect H21's leverage to remain high in FY2021, with debt to adjusted EBITDA at just above 20x, similar to FY2020, before gradually falling to just below 16x in FY2023. Consequently, we expect EBITDA interest coverage to remain tight in FY2021, at 1.2x, before improving to 1.6x in FY2023.

Liquidity

We consider that H21's liquidity position to be very strong. We project sources of liquidity to cover uses by about 1.75x, largely supported by H21's current cash position. However, we expect the ratio to strengthen throughout the year, as we expect H21 to pre-fund its development capex.

Sources of liquidity include:

- Cash and liquid investments of close to £140 million as of June 30, 2020;
- Adjusted EBITDA as a cash flow proxy of £34 million;
- Undrawn committed bank facilities of £25 million; and
- Grants of just under £11 million.

Uses of liquidity include:

- Adjusted capex of close to £80 million; and
- Interest and principal payable of just under £45 million.

We continue to view H21's access to external liquidity as satisfactory.

Outlook

The stable outlook reflects our view that demand will remain strong for H21's rental homes and services, which, together with the group's focus on developing new rental units, will drive the improvement we forecast in its financial performance.

We could lower the ratings should H21's financial performance not recover in line with our forecasts after the pandemic, resulting in weaker debt metrics and liquidity than we expect, without corrective measures by management. We could also lower the rating should management change strategy to one that exposes the group to more risk, namely a heavier reliance on sales receipts.

We could raise the rating on H21 if we saw a sustained improvement in its financial performance. We would expect to see the group's adjusted EBITDA margins improving structurally to above 20%. At the same time, we would expect to see exposure to sales-related activities remain low, such that sales receipts did not account for over 15% of revenues.

Key Statistics

Table 1

Housing 21 Key Statistics

	--Year ended March 31--				
(Mil. £)	2019a	2020e	2021bc	2022bc	2023bc
Number of units owned or managed	21,009	21,072	21,340	22,045	22,774
Revenue§	184.7	193.0	192.9	226.0	225.9
Share of revenue from sales activities (%)	1.3	3.0	3.7	12.0	6.5
EBITDA§†	33.2	27.9	32.6	38.8	45.1
EBITDA/revenue §†(%)	18.0	14.5	16.9	17.2	20.0
Capital expense†	31.8	79.1	63.7	126.1	146.3
Debt	602.1	570.2	652.5	633.7	703.9
Debt/EBITDA §†(x)	18.1	20.4	20.0	16.3	15.6
Interest expense*	27.0	26.0	27.0	27.6	28.6
EBITDA/interest coverage§†* (x)	1.2	1.1	1.2	1.4	1.6
Cash and liquid assets	215.1	145.4	201.9	101.0	75.9

§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

Housing 21 Ratings Score Snapshot

Industry risk	2
Economic fundamentals and market dependencies	2
Strategy and management	2
Asset quality and operational performance	2
Enterprise profile	2
Financial performance	5
Debt profile	3
Liquidity	2
Financial policies	3
Financial profile	4

S&P Global Ratings bases its ratings on non-profit 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Global Social Housing Ratings Score Snapshot: July 2020, July 14, 2020
- Global Social Housing Ratings Risk Indicators: July 2020, July 14, 2020

Ratings List

Ratings Affirmed	
Housing 21	
Issuer Credit Rating	A/Stable/--
Senior Secured	A