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Research Update:

U.K.-Based East Midlands Housing Group Ltd. 'A+' Rating Affirmed; Outlook Remains Stable

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Overview

- East Midlands Housing Group Ltd. (EMH) remains focused primarily on traditional, core social housing services.
- Therefore, we expect the demand for its main source of revenue will remain stable, supporting its very strong enterprise risk profile.
- In our view, external factors such as welfare reforms will exert downward pressure on financials but we expect the strong financial risk profile to be maintained.
- We are therefore affirming our 'A+' long-term issuer credit rating on EMH. The stable outlook reflects our view that EMH will only gradually increase its exposure to sales, and that its adjusted EBITDA margin will stay above 30% of revenues.

Rating Action

On Jan. 5, 2017, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K. social housing provider East Midlands Housing Group Ltd. (EMH). The outlook remains stable.

At the same time, we affirmed our 'A+' issue rating on the £200 million senior secured debt issued by its subsidiary EMH Treasury PLC and guaranteed by EMH Group. EMH Treasury PLC was set up for the sole purpose of issuing bonds, and we view it as a core subsidiary of the EMH Group.

Rationale

The 'A+' rating on EMH is based on its stand-alone credit profile (SACP), which we assess at 'a+'. The supporting elements of the SACP are the low risk nature of the social housing industry, stability in EMH's strategic management, moderately high demand for its core traditional activities, and high quality property portfolio. We also consider EMH's liquidity to be strong, with moderate levels of leverage. The constraining factors for the rating are the increasing, albeit from a modest base, exposure to non-traditional activities and welfare reforms that weigh on the financial performance.

Our assessment of the very strong enterprise profile incorporates the mid-sized portfolio base of about 19,000 units. A portion of the stock is based in Blaby, Leicester, and Coalville, where management has close ties with the local authorities. Furthermore, we view positively EMH's primary focus on sub-market rental activities (traditional social housing)--over 80% of the stock relates social housing (and accounts for about 78% of revenues). The stock is considered to be in good condition, and is 100% compliant with the U.K. government's Decent Homes Standard.

We view positively that management's strategic planning is robust and in line with the organization's capabilities. At the same time, management demonstrates prudent risk management regarding development scale. The current strategy indicates that EMH will not develop more than 350 units, on average, over the next three years. This level of development remains within capacity and is currently fully funded.

Although historically EMH's current arrears have consistently remained below 4% of net rent receivable, the roll-out of universal credit poses challenges to rent collection. The experience from the existing tenants on universal credit indicates a sharp increase in arrears. Therefore, we anticipate that arrears will increase by 1% above our base case to about 4.1% of net rent receivable by the financial year (FY) ending March 31, 2019, as universal credit reaches most working age tenants by mid-2017.

Welfare reforms announced by the U.K. government will likely weigh negatively on the underlying profitability of EMH. In particular, a government directive to cut social rents by 1% for four years can have implications for the whole sector, even more so for registered providers such as EMH whose revenues are highly dependent on rental revenue from social housing. The U.K.'s referendum vote to leave the EU poses additional risks, in so far as a decline in pound sterling is already set to inflate input and associated costs.

That said, in our opinion, EMH will likely retain its strong financial performance with adjusted EBITDA margins above 30% of revenues, on average, over our five-year base case to FY2019. We base this on EMH achieving its efficiency plan of £4 million of savings by 2020. We view it as positive that £1.4 million of these savings will be delivered by FY2017. Major savings are expected from efficiencies achieved by digitalization and staff restructuring.

EMH continues to have a limited appetite for development for sale and market rental properties and intends to focus its development largely on social housing lettings. Of the 350 homes to be built over the next two years, 80% will be affordable. Shared ownership will see an increasing share of development, but at modest levels of around 15% of total development annually until 2019. Notably, almost 50% of this development remains uncommitted. Therefore, EMH could curtail an element of uncommitted development, if needed. We also note that the proceeds from Right to Buy (RTB) have not been factored into the development funding plan. Therefore, any proceeds from RTB will reduce the need for additional borrowing in the future.

EMH's leverage is modest, in our view, with debt to EBITDA averaging 13.4x over 2015-2019. We do not expect debt to materially increase as the development plan is mostly funded with cash, current committed facilities, and ongoing surplus. We expect EMH to draw on credit facilities available of £39.75 million for development use over the coming years. On the other hand, projected EBITDA is likely to remain under pressure--through a combination of lower rental income due to rent cuts and a larger than expected increase in input costs. We expect the debt level to peak at 14x by FY2019. The group pays a fixed rate on 97% of existing debt.

The rating also reflects our opinion of a moderately high likelihood that the U.K. government, working through the Homes and Communities Agency (HCA), would provide timely and sufficient extraordinary support in the event of financial distress. In accordance with our criteria for government-related entities (GREs), our view of a moderately high likelihood of extraordinary government support is based on our assessment of EMH's important role for the U.K. government and its public policy mandate. It is also supported by our view of EHM's strong link with the U.K. government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

Liquidity

We consider EMH's liquidity position to be strong. We base this assessment on the substantial cash holdings of £50 million, as of September 2016. This is further buoyed by £39.75 million of committed, yet undrawn facilities. Although total committed and undrawn facilities amount to about £100 million, we only factor the portion that is fully collateralized--therefore available to draw at short notice.

Our sources of cash total about £139 million (the other major component being cash from operations). These sources are expected to cover uses by 1.7x over the next 12 months.

In our analysis, capital expenditure on the development program forms the major use of liquidity--which we estimate will require about £53 million. In addition, the debt service (including both interest and principal payments) over 12 months amounts to about £30 million.

Outlook

The stable outlook reflects our view that EMH will only gradually increase its exposure to sales, and that its adjusted EBITDA margin will stay above 30% of revenues.

We could lower the rating on EMH if we anticipate a higher proportion of revenues from riskier sources, such as shared ownership and market sales. This puts pressure on EMH's economic fundamentals and financial performance as the earnings from such sources are more volatile, in our view. We could also downgrade EMH if the underlying profitability came under pressure with EBITDA falling below our base-case expectation of 30%-32% of revenues.

We may raise the rating if EMH demonstrates strong willingness to deleverage (debt to adjusted EBITDA declining below 10x), along with a marked improvement in the underlying profitability and its liquidity position. However, we view this as unlikely over the next 24 months.

East Midlands Housing Group Ltd Financial Statistics

	--Year Ended March-31--				
('000 £)	**2015a**	**2016a**	**2017bc**	**2018bc**	**2019bc**
Number of units	17,569	17,860	17,995	18,256	18,467
Vacancy rates (% of net rental income)	2.3	1.7	2.0	1.6	1.6
Arrears (% of net rental income)*	3.7	3.1	3.6	4.1	4.1
Revenue	94,741	96,626	95,700	96,200	96,900
Share of revenue from non-traditional activities (%)	21.0	19.5	17.7	17.7	17.8
Operating expense	67,020	71,372	68,971	70,754	71,652
EBITDA§	30,523	31,621	29,729	28,146	28,848
EBITDA/revenue (%)	32.2	32.7	31.1	29.3	29.8
Interest expense	21,663	21,797	21,060	20,089	19,810
Debt/EBITDA (x)	12.2	12.7	13.3	13.8	14.1
EBITDA/interest coverage (x)†	1.4	1.5	1.4	1.4	1.5
Capital expense	45,636	47,849	43,700	24,100	43,200
Debt	370,953	403,015	394,900	389,800	406,600
Housing properties (according to balance-sheet valuation)	658,378	691,974	717,588	743,608	784,848
Loan to value of properties (%)	56.3	58.2	55.0	52.4	51.8
Cash and liquid assets	48,964	59,509	34,109	31,509	41,009

*Current arrears. §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 - November 9, 2016
- Credit FAQ: Brexit Uncertainties Mean Higher Credit Risk And Lower Ratings For The U.K. Social Housing Sector, Oct. 31, 2016
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative On Brexit Uncertainties - Oct. 28, 2016

Ratings List

	Rating	
	To	From
East Midlands Housing Group Ltd		
Issuer Credit Rating		
Foreign and Local Currency	A+/Stable/--	A+/Stable/--
EMH Treasury PLC		
Senior Secured		
Local Currency[1]	A+	A+

[1] Dependent Participant(s): East Midlands Housing Group Ltd

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.