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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. (EMHG) is improving its operating performance through cost control and remains focused on low-risk social housing.
- We see high demand for EMHG's services, supporting steady financial performance.
- We are therefore affirming our 'A+' long-term issuer credit rating on EMHG.
- The stable outlook is based on our view that EMHG is unlikely to expose more than 25% of its revenues to market-related activities through FY2020.

Rating Action

On Jan. 3, 2018, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K. social housing provider East Midlands Housing Group Ltd. (EMHG). The outlook remains stable.

At the same time, we affirmed our 'A+' long-term issue rating on the £200 million senior secured debt issued by EMHG's subsidiary EMH Treasury PLC and guaranteed by EMHG. EMH Treasury PLC was established for the sole purpose of issuing bonds and lending the proceeds to EMHG and we view it as a core subsidiary of EMHG.

Rationale

The 'A+' rating on EMHG is supported by strong demand for its services in the low-risk social housing industry. EMHG has continued to reduce vacancy rates to below 2%, highlighting effective management of its high-quality asset base. Plans to increase development in shared ownership sales, which could erode the high quality of earnings, constrain the rating.

EMHG is a midsized housing association, based in the U.K.'s Midlands. The area is economically less dynamic than the southeast of England, but attracts high demand for both social housing and other market-related activities, in particular shared ownership. The group has about 20,000 units under management and predominantly focuses on its core activity--low-risk social housing letting. This supports steady operational and financial performance. As of the end of financial year (FY) 2017, revenues from this activity accounted for more than 80% of total revenues.

Even though EMHG plans to materially increase development of shared ownership properties from FY2020, we anticipate the revenues from first-tranche sales will remain below 15% of total revenue in that year. Nonetheless, the increase exposes the group to risks that are associated with the volatility of market-related activities.

The group has improved the quality of its asset base by effective management of its properties. Although arrears have remained low at around 3.5% of revenues, we consider arrears to be a risk factor for the group as Universal Credit is fully rolled out. A small proportion of EMHG tenants are in receipt of Universal Credit and this subset has higher arrears than the group average.

The management team at EMHG are very experienced, and have a robust framework for strategic planning. Development focuses on affordable rent, with an increasing bias toward shared ownership units, but no riskier outright sales. The increase in shared ownership development is a slight deviation from the group's usual, more traditional, strategy.

EMHG plans to significantly increase development to about 1,300 units between FY2018 and FY2020. These will be a mixture of social, affordable, and shared ownership. We expect that for the first two years, around 300 units will be developed annually. Thereafter, the number will increase substantially to around 700 units in FY2020. Of these units, we expect 850 (65%) to be affordable and rest to be shared ownership. We note that more than 90% of the development in FY2020 remains uncommitted at this point, therefore EMHG has flexibility to adapt if needed.

EMHG's steady financial performance gives us comfort that the group's adjusted EBITDA margin will remain above 30% of revenues. The group delivered £1.9 million in efficiency savings, thereby increasing its EBITDA margin by 5% and reaching 37% in FY2017. We believe management's target of total savings of £4.7 million by FY2020 could be achieved, primarily by restructuring its maintenance team and closing redundant offices. In our base-case scenario, we forecast that S&P Global Ratings-adjusted EBITDA margins will shrink over the next two years due to rent cuts and increased development in nontraditional activity, but remain above 30%.

We forecast debt will gradually increase, peaking at around £455 million in FY2020 because we anticipate that EMHG will draw on its available committed lines to fund its development program. In our base-case scenario, we expect average adjusted debt to EBITDA to remain moderate at around 12x over the next two years, while average adjusted EBITDA to interest cover will be 1.5x.

The 'A+' rating is the same as the stand-alone credit profile, reflecting our opinion of a moderately high likelihood that the U.K. government (AA/Negative/A-1+), working through the Homes and Communities Agency (HCA), would provide timely and sufficient extraordinary support in the event of financial distress. We base this view on EMHG's important role for the U.K. government and its public policy mandate, and its strong link with the U.K. government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

Liquidity

We assess EMHG's liquidity position as strong, with sources of liquidity covering uses by 1.7x over the next 12 months. We attribute the slight improvement on last year to our forecast of slightly lower capital expenditure, combined with an increase in available undrawn committed facilities.

We forecast that sources of liquidity will amount to £110 million and consist largely of:

- Cash flow from operations of £40 million,
- £50 million from undrawn committed facilities, and
- £20 million in cash and liquid investments.

We forecast uses of liquidity will amount to £64 million and consist of:

- £41 million of expected capital expenditure, and
- £23 million of debt repayments.

Outlook

The stable outlook reflects our expectation that EMHG will continue to focus its operations on traditional social housing activities, thereby limiting its exposure to the volatility associated with market-related activities.

We could lower the rating if we were to observe a structural increase in nontraditional activities, such that shared ownership, first-tranche sales receipts accounted for over 15% of total revenues.

We could raise the rating if we saw an improvement in the overall profitability of the group. We would also expect to see an improvement in the group's debt profile, where adjusted debt to EBITDA fell below 10x.

East Midlands Housing Group Ltd Key Statistics

	--Year Ended March 31--				
(Mil. £)	**2016a**	**2017a**	**2018bc**	**2019bc**	**2020bc**
Number of units owned or managed	19,506	19,844	20,156	20,445	21,022
Vacancy rates (% of rent net of identifiable service charge)	1.8%	1.4%	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	3.3%	3.5%	N.A.	N.A.	N.A.
Revenue§	96.6	99.0	99.2	101.7	113.5
Share of revenue from non-traditional activities (%)	18%	18%	17%	18%	25%
EBITDA¶	30.7	36.9	35.6	34.9	36.5
EBITDA/revenue (%)	31.8	37.3	35.9	34.3	32.2
Interest expense	21.6	21.7	22.3	23.1	25.8
Debt/EBITDA (x)	13.2	10.8	11.3	11.9	12.5
EBITDA/Interest coverage† (x)	1.4	1.7	1.6	1.5	1.4
Capital expense	39.7	39.9	40.0	41.2	46.9
Debt	405.2	399.7	400.4	415.5	455.7
Housing properties (according to balance sheet valuation)	702.6	733.3	768.0	803.8	845.0
Loan to value of properties (%)	57.7	54.5	52.1	51.7	53.9
Cash and liquid assets	59.5	40.2	17.4	6.9	14.4

*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 Scenario Analysis: What Could Happen To Ratings In A Market Downturn? – September 25, 2017
- Global Social Housing Risk Indicators – June 9, 2017
- High Demand For U.K. Social Housing Will Push Sector's Debt Above £80 Billion In FY2019 – March 20, 2017

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.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)

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