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Research Update:

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

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Overview

- East Midlands Housing Group Ltd. (EMH), a recently announced strategic partner of Homes England, is seeking to develop 2,600 properties by the financial year 2023.
- Two thirds of the development plan will comprise general needs housing, which will continue to support EMH's strong financial performance.
- We are therefore affirming our 'A+' long-term issuer credit rating on EMH.
- The stable outlook is based on our view that EMH will continue to derive the majority of its revenues from traditional sources, keeping exposure to care services and sales-related activities low.

Rating Action

On Jan. 4, 2019, 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+' long-term issue rating on the £200 million senior secured debt issued by EMH's subsidiary, EMH Treasury PLC, and guaranteed by EMH. EMH Treasury was established solely for issuing bonds and lending the proceeds to EMH and we view it as a core subsidiary of EMH.

Rationale

The 'A+' rating is supported by EMH's decision to focus on social housing lettings and keep exposure to sales activity low. While we expect around one third of EMH's development plan to be shared ownership, under our base case, we forecast that sales exposure will not exceed 15% of total revenues. We also expect that nontraditional activities in general, which for EMH mainly comprise care services and first-tranche sales, will continue to account for below 25% of total revenues.

EMH's decision to continue focusing on social housing lettings is credit positive as this sector benefits from low industry risk. It is monitored closely by the Regulator of Social Housing and is naturally anticyclical, which shields EMH's revenue stream somewhat from a downturn in the housing market. However, offsetting the low industry risk is the lower demand for social housing in the East Midlands region than in other regions. According to data published by the Office for National Statistics, average social rents in the East Midlands are around 70% of market rents. In comparison, average social rents are 41% of market rents in London and 56% in the Southeast. If social rents are close to market rents then prospective tenants may opt for market rented accommodation instead.

EMH's asset quality remains a rating strength, supported by continually improving operational metrics. Vacancy rates, which had been higher than average for EMH (generally below 2% of net rent receivable) have improved for a third consecutive year, falling to 1.2% in the financial year ending March 31, 2018 (FY2018) from 1.3% in FY2017. Gross arrears fell to 5.2% of net rent receivable in FY2018, down from 5.7% in FY2017. EMH is positioning itself for the impending roll-out of Universal Credit and is looking to use its status as a Trust Partner with the Department of Work and Pensions to identify vulnerable tenants.

EMH's management has had a new addition in the last year; a new director of development will look to maximize EMH's development potential. We continue to view management's decision to focus on traditional activities as risk-averse and view positively the executive team's vast experience.

In July 2018, EMH was announced as one of eight strategic partners within Homes England's first wave of new partnerships. Consequently, EMH will receive around £30 million of grant funding to help deliver 748 new homes by FY2022. Successful grant funding has allowed EMH to reassess its development program ambitions and is aiming to deliver 2,600 new homes by FY2023. We expect two thirds of EMH's development plan will be for general needs rent and the remaining third will mainly consist of shared ownership. EMH will build some units for outright sale as part of multi-tenured schemes, but we expect them to account for less than 2% of total development.

EMH's development for shared ownership will weigh on financial performance slightly. However, due to stronger EBITDA margins historically, we expect five-year average adjusted EBITDA margins (reported EBITDA adjusted for capitalized repairs and amortized grants) to be around 35% in our base case. The ability to increase rents from FY2021--combined with continued growth in EMH's general needs asset base--could contribute to an improvement in margins from FY2021, depending on sales volume.

To facilitate EMH's planned development, we believe that more debt will be required resulting in total debt increasing to around £410 million in FY2019, peaking at £465 million in FY2021. The timing of the impending government grants from the partnership with the Homes England could result in lower debt for FY2019, but overall, it will not materially change the debt stock we forecast in our base case. Despite the planned increase in debt, we forecast five-year adjusted debt to EBITDA to average 11.5x and EBITDA to interest cover to average 1.7x. Due to EMH's traditional revenue base, we estimate EBITDA generated from social housing lettings alone will be sufficient to cover interest by 1.4x between FY2019 and FY2021.

The 'A+' rating on EMH is the same as the stand-alone credit profile, reflecting our opinion of a moderately high likelihood that the U.K. government, working through the Regulator of Social Housing, would provide timely and sufficient extraordinary support in the event of financial distress. Our assessment is based on our view that EMH plays an important role in the provision of social housing for the U.K. government and its strong link to the government, demonstrated by its track record of supporting the sector.

Liquidity

We assess EMH's liquidity position as strong, supported by sources of liquidity covering uses by 1.7x over the next 12 months. EMH's uses are supported by the two available RCFs totaling £93 million. We acknowledge that EMH will likely receive government grants over the next 12 months and factor them into our cash flow forecasts. However, we do not believe they will materially improve EMH's liquidity position.

We forecast liquidity sources will amount to £154 million and comprise:

- Cash generated through operations: £36 million
- Cash and liquid investments: £21 million
- Proceeds from asset sales: £5 million
- Undrawn committed facilities: £93 million

We forecast uses of liquidity will amount to around £102 million and comprise:

- Capital expenditure: £76 million
- Interest and principal repayments: £27 million

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

Outlook

The stable outlook reflects our opinion that EMH will continue to focus on its traditional social housing lettings business while undertaking its ambitious development plan. Keeping sales exposure low will shield its revenues from the volatility and uncertainty associated with revenues generated on the private market.

We could lower the rating on EMH if exposure to both shared ownership first-tranche and outright sales increased more than expected under our base case, such that they account for over 15% of revenues.

We could raise the rating if we saw an improvement in EMH's financial performance, such that adjusted EBITDA margins structurally improved toward 40%. Such an improvement in adjusted EBITDA would also result in strengthening debt to EBITDA, such that it trended below 10x.

Table 1

East Midlands Housing Group Ltd. Key Statistics

	--Year ended March 31--				
(Mil. £)	**2017a**	**2018a**	**2019bc**	**2020bc**	**2021bc**
Number of units owned or managed	19,844	20,124	20,461	20,934	21,421
Vacancy rates (% of rent net of identifiable service charge)	1.3	1.2	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	5.5	5.2	N.A.	N.A.	N.A.
Revenue§	99.0	99.3	102.2	108.3	109.6
Share of revenue from nontraditional activities (%)	18.1	18.3	20.2	23.6	20.8
EBITDA†	36.9	37.2	34.9	35.9	37.8
EBITDA/revenue (%)	37.3	37.4	34.1	33.1	34.5
Interest expense	21.7	20.6	21.1	22.4	23.9
Debt/EBITDA (x)	10.8	10.4	11.8	12.2	12.3
EBITDA/interest coverage** (x)	1.7	1.8	1.7	1.6	1.6
Capital expense†	39.9	33.9	67.6	67.1	67.8
Debt	399.7	384.9	410.2	436.3	465.2
Housing properties (according to balance sheet valuation)	733.3	756.1			
Loan to value of properties (%)	54.5	50.9			
Cash and liquid assets	40.2	25.2	21.7	23.8	29.8

*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.

Table 2

East Midlands Housing Group Ltd. Ratings Score Snapshot

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Strategy and management	2
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Enterprise profile	2
Financial performance	3
Debt profile	3
Liquidity	3
Financial policies	2
Financial profile	3

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: Group Rating Methodology, Nov. 19, 2013
- 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

- Countdown to Brexit: No Deal Moving Into Sight, Oct. 30, 2018
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, Oct. 26, 2018
- U.K. Social Housing Providers To Borrow £12 Billion Of New Debt By 2020, Total Debt to Reach £89 Billion, March 7, 2018
- New Rent Policy Brings Relief, But No Big Boost To The Credit Standing Of U.K. Housing Associations, Jan. 31, 2018
- Global Social Housing Risk Indicators: January 2018, Jan. 30, 2018
- U.K. Social Housing Scenario Analysis: What Could Happen To Ratings In A Market Downturn? Sept. 25, 2017

Ratings List

Ratings Affirmed

East Midlands Housing Group Ltd	
Issuer Credit Rating	A+/Stable/--
EMH Treasury PLC	
Senior Secured	A+