Research Update:

U.K.-Based Social Housing Provider Karbon Homes Ltd. Outlook Revised To Positive; 'A' Ratings Affirmed

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Overview

- S&P Global Ratings forecasts that U.K. social housing provider Karbon Homes Ltd. will maintain relatively strong key financial metrics despite challenges affecting the social housing sector.
- We anticipate that Karbon will increase investment in its existing properties over the next two years while ramping up development of new homes.
- However, we project that rental revenue from acquired units and significant development grants will reduce the group's debt funding need more than we had assumed, resulting in relatively strong credit metrics.
- We revised our outlook on Karbon to positive from stable and affirmed our 'A' long-term issuer credit rating on the group.

Rating Action

On May 18, 2023, S&P Global Ratings revised its outlook on U.K. social housing provider Karbon Homes Ltd. to positive from stable. At the same time, we affirmed our 'A' long-term issuer credit rating on Karbon and our 'A' issue rating on the £250 million bond issued by Karbon Homes.

Outlook

The positive outlook reflects our expectation that rental revenue from acquired units and development grants will reduce the group's debt funding need more than we had assumed, resulting in relatively strong credit metrics.

Upside scenario

We could raise our ratings on Karbon over the next two years if the group maintains very strong debt metrics despite ramping up capital expenditure (capex) to deliver a large development plan, while integrating acquired units and increasing investment in existing homes.

Downside scenario

We could revise the outlook to stable if an expansion of Karbon's development plan or acquisition of additional units were to require more debt funding, which could weigh on its debt metrics. An outlook revision to stable could also follow if the group's maintenance spend increases more than we have assumed, which could result in lower-than-expected S&P Global Ratings-adjusted EBITDA and lead to pressure on key financial metrics.

Rationale

The outlook revision reflects our view that Karbon's adjusted debt metrics and liquidity are relatively strong compared with those of many rated peers. We consider that, amid external regulatory and economic challenges, maintaining key financial metrics could reflect positively on our assessment of the group's management. This would particularly be the case if Karbon integrates recently acquired subsidiaries while investing more in its existing stock and ramping up capex to deliver its development plan, without materially affecting its very strong debt metrics.

We understand that Karbon will receive a significant amount of grant funding that, combined with cash proceeds from a previously issued bond and higher-than-expected rental revenue from recently acquired units, support better adjusted debt metrics than we had projected. Specifically, we forecast that the group's nonsales adjusted EBITDA will be higher than we had assumed, and combined with lower-than-expected debt levels, will lead to better-than-forecast debt metrics. Specifically, we expect a debt-to-nonsales adjusted EBITDA ratio of just over 13x by March 31, 2026, whereas we had projected debt to nonsales adjusted EBITDA would exceed 14x by March 31, 2025.

Enterprise profile: Underpinned by focus on general needs rent, cautious approach to sales risk, and solid operational metrics

Karbon benefits from generating most of its earnings in the predictable and countercyclical social housing sector, supported by a solid market position and generally cautious approach to sales risk. The group owns and manages about 30,000 homes in the northeast of England and has a foothold further south, in Yorkshire, through subsidiary 54North Homes. It continues to see strong demand for its properties, as seen in solid operational metrics. Karbon's average social and affordable rents are relatively high, at more than 75% of the average market rent in the region. However, its vacancy rates are decreasing, to 1.4% in fiscal 2023 from 2.2% two years ago, with the average over the past three years being about 1.8%, which we consider on par with the sector average.

Following the addition of the 1,800 units from Byker Community Trust that joined the Karbon group April 1, 2021, Leeds and Yorkshire Housing Association joined the Karbon group in December 2022 by merging with Karbon's subsidiary York Housing (together 54North Homes), adding more than 1,600 units. While Leeds and Yorkshire Housing Association brought debt to the group, our view is that it would have no material impact on Karbon's credit metrics because it would be offset by the earnings from the additional rental units.

We view the group's strategy as consistent with its operational capacity, further underpinned by

Karbon's experienced management team and solid risk management policies. While the main part of the group's development program is linked to its Strategic Partnership with Homes England, and therefore less flexible in terms of delivery, we consider that about 50% of Karbon's capex spend remains uncommitted over the next two years, providing flexibility if needed. We understand that the continuously increasing investment in existing stock are made with the group's financial policies in mind, to ensure maintained solid headroom within lenders' covenants. We also note positively the group's strong focus on asset quality, including the work to bring all its homes to the Energy Performance Certificate (EPC) C level by 2030. Karbon has about 70% of its stock at EPC C or above, is above the English sector average of just above 50%.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (for more information, see "Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers," published June 8, 2021, on RatingsDirect).

Financial profile: Prefunding and significant grants alleviate Karbon's debt funding need, resulting in maintained very strong debt metrics and liquidity

We understand that Karbon will receive a significant amount of front-loaded grant funding from Homes England for the development of new units, which, combined with cash proceeds from the issuance in June 2020 of the £100 million that was retained on its £250 million bond issue and higher-than-expected rental revenue from additional units support better adjusted debt metrics than we had projected.

In addition to stronger-than-forecast debt to nonsales adjusted EBITDA ratios, we project that the group's nonsales adjusted EBITDA interest coverage will remain solid, at about 2x over the next three years. It is also our view that liquidity coverage will remain very strong, supported by the grant funding that would finance the peak of the group's capex through to March 31, 2024. We project that the group's adjusted EBITDA margins will be largely in line with our previous base-case scenario, at about 23% over the next two years, because increasing investment in the group's existing homes and inflation-driven cost increases largely offset the higher revenue.

We assess Karbon's liquidity position as very strong, with sources covering uses by 2x in the next 12 months. This is based on our forecast of liquidity sources of about £410 million (mainly cash and undrawn available facilities, grant receipts, and cash from operations (adding back the noncash cost of sales), compared with liquidity uses of about £200 million (primarily capex, and interest and principal payments). We also consider that Karbon has satisfactory access to external funding when needed.

Government-related entity analysis

We believe there is a moderately high likelihood that Karbon would receive timely extraordinary government support in case of financial distress. This provides a one-notch uplift from the stand-alone credit profile. As one of the Regulator of Social Housing's (RSH's) key goals is to maintain lender confidence and low funding costs across the sector, we believe it is likely that the RSH would likely step in to try to prevent a default in the sector. We base this view on previous records of the RSH mediating mergers or arranging liquidity support from other registered providers in cases of financial distress.

Selected Indicators

Table 1

Karbon Homes Ltd.--Key Statistics

	--Year ended March 31--				
Mil. £	**2022a**	**2023e**	**2024bc**	**2025bc**	**2026bc**
Units owned or managed	29,649	31,716	32,832	33,586	34,366
Adjusted operating revenue	150.0	152.6	174.5	198.8	208.2
Adjusted EBITDA	41.5	36.9	40.8	45.5	48.5
Nonsales adjusted EBITDA	39.0	35.2	39.0	43.3	46.2
Capital expense	68.8	65.3	178.9	150.9	124.7
Debt	466.8	454.7	450.3	538.1	615.4
Interest expense	18.5	18.9	18.5	20.6	24.7
Adjusted EBITDA/Adjusted operating revenue (%)	27.6	24.2	23.4	22.9	23.3
Debt/nonsales adjusted EBITDA (x)	12.0	12.9	11.5	12.4	13.3
Nonsales adjusted EBITDA/interest coverage(x)	2.1	1.9	2.1	2.1	1.9

bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. a--Actual. e--Estimate. N.A.--Not available.

Ratings Score Snapshot

Table 2

Karbon Homes Ltd.--Ratings Score Snapshot

Enterprise risk profile	**3**
Industry risk	2
Regulatory framework	3
Market dependencies	4
Management and Governance	3
Financial risk profile	**3**
Financial performance	4
Debt profile	2
Liquidity	2

S&P Global Ratings bases its ratings on non-profit social housing providers on the seven main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published on June 1, 2021, summarizes how the seven factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021

- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing Providers , June 1, 2021
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions , March 25, 2015
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating , Oct. 1, 2010

Related Research

- United Kingdom Outlook Revised To Stable From Negative On Moderating Fiscal Risks; 'AA/A-1+' Ratings Affirmed; April 21, 2023
- U.K. Social Housing Borrowing 2023: On Pause, March 28, 2023
- Non-U.S. Social Housing Providers Ratings Score Snapshot: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings Risk Indicators: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings History: March 2023, March 27, 2023
- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022
- Non-U.S. Social Sector Outlook 2023: The Most Negative Bias Since 2018 Implies Significant Pressure On Ratings, Dec. 1, 2022
- Inflation To Erode The Performance Of U.K. Public Finance Sectors, Nov. 29, 2022
- Bulletin: Cap On Rent Increases Is Consistent With Our Base Case For English Social Housing Providers, Nov. 17, 2022
- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 2022
- Bulletin: Launch Of Rent Cap Consultation Adds Uncertainty To Creditworthiness Across English Housing Sector, Sept. 1, 2022
- Rated U.K. Social Housing Providers' Creditworthiness Could Suffer If The Gap Between Rent And Cost Increases Persists, Aug. 1, 2022
- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers Published, June 8, 2021

Ratings List

Ratings Affirmed		
Karbon Homes Ltd.		
Senior Secured	A	
Ratings Affirmed;Outlook Action		
	To	**From**
Karbon Homes Ltd.		
Issuer Credit Rating	A/Positive/--	A/Stable/--

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914