Research Update:

U.K.-Based Social Housing Association Karbon Homes Ltd. 'A+' Rating Affirmed; Outlook Negative

October 29, 2019

Overview

- Focus on core business of low-income social housing activities, combined with its robust liquidity position, helps Karbon Homes balance the economic challenges associated with operating in the northeast of England.
- We are affirming our 'A+' long-term rating on Karbon Homes.
- The negative outlook on Karbon Homes signifies that limited financial flexibility may weigh on financial performance, leading to higher debt levels or a weakening of its currently very strong liquidity position.

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Rating Action

On Oct. 29, 2019, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K. social housing provider Karbon Homes Ltd. The outlook is negative.

At the same time, we affirmed our 'A+' issue rating on the £150 million bond Karbon Homes issued in November 2018.

Rationale

We affirmed the rating because the risks Karbon Homes is exposed to from operating in the northeast of England are balanced by its focus on traditional activities and its strong financial profile.

We rate Karbon Homes one notch above its stand-alone credit profile, based on the moderately high likelihood that the U.K. government--working through the Regulator of Social Housing (RSH)--would provide timely and sufficient extraordinary support to the association in the event of financial distress. We consider that English registered social housing providers play an important role in the public policy mandate of the government.

Karbon Homes is one of the three largest social housing providers in the northeast. It currently owns and manages about 27,000 units. It was created in April 2017, after the merger of three social housing associations: Isos Housing, Cestria Community Housing, and Derwentside Homes.

Our assessment of Karbon Homes enterprise risk profile is underpinned by its focus on its core business of low-income social housing activities. This supports our view of predictable revenue streams and low industry risk. We view the social housing industry as low risk, predominantly due to its anticyclical nature and strong oversight from the RSH. Karbon Homes' updated business plan anticipates that it will scale down its development for sale activities. We therefore expect revenues from nontraditional activities to remain low at just 10% of total revenues.

Karbon Homes has a strong geographical focus in the northeast of England, which is characterized by sluggish economic growth and high unemployment. This reduces its financial flexibility and leads to high arrears.

Average social housing rents in this region are around 70% of market rents. Gross arrears have increased during the financial year ending March 2019 to above 6% of total rental income. We chiefly attribute the increased arrears to a threefold increase in Universal Credit claimants. We anticipate that arrears will remain relatively high because Karbon Homes is likely to increase rents from 2021 after the rent cut regime. On the positive side, vacancy rates have remained very low, even compared with peers and despite a one-off slight increase caused by unexpected maintenance of the stock Karbon Homes acquired from The Guinness Partnership last year.

Karbon Homes' management is still working through some of the constraints linked to consolidating the strategies of its founding associations. In our view, this limits its flexibility to boost its performance in some areas of operations, as demonstrated by the recent track record of underperformance on sales activities due to one legacy scheme. Going forward, we expect positive margins on sales activities overall.

That said, the team has extensive experience of working in the social housing sector, and the group's overall strategy is conservative and aligned with the risks of its areas of operations. A system of internal controls and oversight of financial golden rules ensures that treasury policies are met. We view its financial policies as prudent and strong.

We project that the group's adjusted EBITDA margins will remain slightly below a moderate 30% through the next two-to-three years. We assume that higher rents beyond 2021 will be balanced by higher capitalized repairs and lower margins from nontraditional activities.

Given Karbon Homes' strategy of delivering 500 homes a year, we expect S&P Global Ratings-adjusted debt to EBITDA to ramp up after FY2020 to slightly above 10x. We forecast Karbon Homes will access funding by issuing £50 million of its £100 million retained bond in FY2021 and the remaining £50 million in FY2022.

During FY2019, Karbon Homes carried its refinancing program, which effectively reduced the cost of debt by replacing legacy loans by issuing a £150 million bond in the markets. The group's refinancing has locked in fixed rates and cut the average interest expense. Interest coverage remains robust, given the current financing terms and management's handling of debt. We expect adjusted EBITDA to be well above 2x during FY2020-FY2022.

Liquidity

We consider that Karbon Homes has a very strong liquidity position, owed to its high levels of cash, substantial amount of undrawn bank lines in preparation for Brexit disruptions, and satisfactory access to capital markets. In our base-case scenario, we estimate sources of cash of £245.2 million will cover uses by 2.3x.

Sources of liquidity include:

- About £38.9 million of cash to be generated from continuing operations over the next 12 months;
- Cash and liquid investments of £66.4 million;
- Proceeds from asset sales of £4.3 million; and
- Undrawn committed bank facilities of £135.5 million.

Uses of liquidity include:

- Expected capital expenditure of about £73.3 million;
- Debt service payments of around £33.2 million; and
- Other payments of £0.2 million.

Our assessment incorporates our view of Karbon Homes' satisfactory access to external liquidity.

Outlook

The negative outlook on Karbon Homes indicates that limited financial flexibility could weigh on financial performance. We could lower the rating if Karbon Homes' financial performance slipped significantly below our base-case scenario, leading to higher debt levels or a weakening of its currently very strong liquidity position.

We could also lower our rating on Karbon Homes if we were to lower our U.K. sovereign rating, because we would no longer factor in one notch of uplift for government support.

We could revise the outlook to stable in the next two years if we took the same action on the sovereign, with Karbon Homes performing in line with our base-case scenario.

Key Statistics

Table 1

Karbon Homes Ltd.

	--Year ended March 31--				
(Mil. £)	**2018a**	**2019a**	**2020e**	**2021bc**	**2022bc**
Number of units owned or managed	25,190	26,834	27,175	27,555	27,911
Vacancy rates (%)*	1.3	1.9	N.A.	N.A.	N.A.
Arrears (%)*	4.4	6.9	N.A.	N.A.	N.A.
Revenue§	122.3	124.3	133.4	137.5	146.3
Share of revenue from nontraditional activities (%)	7.2	6.4	10.6	9.1	10.8
EBITDA§†	36.1	38.2	37.8	40.6	39.4
EBITDA/revenue §†(%)	29.5	30.7	28.3	29.5	27.0
Interest expense**	12.5	18.0	18.0	18.2	18.5
Debt/EBITDA §†(x)	8.0	10.3	9.9	10.1	10.6
EBITDA/interest coverage§†** (x)	2.9	2.1	2.1	2.2	2.1

Table 1

Karbon Homes Ltd. (cont.)

	--Year ended March 31--				
(Mil. £)	**2018a**	**2019a**	**2020e**	**2021bc**	**2022bc**
Capital expense†	42.4	104.9	69.6	78.4	32.2
Debt	287.1	394.8	374.0	409.7	418.1
Housing properties (according to balance sheet valuation)	739.2	822.2	N.A.	N.A.	N.A.
Loan to value of properties (%)	38.8	48.0	N.A.	N.A.	N.A.
Cash and liquid assets	38.9	74.0	32.8	36.3	46.7

*Rent and service charge. §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

Karbon Homes Ltd. Ratings Score Snapshot

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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

Ratings List

Ratings Affirmed	
Karbon Homes Ltd.	
Issuer Credit Rating	A+/Negative/--
Senior Secured	A+