S&P Global
Ratings

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Research Update:

U.K.-Based Social Housing Provider Karbon Homes Ltd. Downgraded To 'A'; Outlook Stable

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Overview

- A strong focus on low-income social housing activities continues to support our rating on Karbon Homes Ltd.
- Nevertheless, S&P Global Ratings estimates that the economic recession in the northeast of England arising from the COVID-19 outbreak would further limit Karbon Homes' financial flexibility compared with peers.
- We are therefore lowering to 'A' from 'A+' our long-term issuer credit rating on Karbon Homes.
- The stable outlook on Karbon Homes signals our view that the estimated weakening EBITDA margins and higher debt will be counterbalanced by Karbon Homes' reliance on more predictable revenue streams. We forecast that EBITDA margins will average about 30% and debt to EBITDA will average 11x through fiscal years (FY) ending March 31, 2021-FY2023.

Rating Action

On May 27, 2020, S&P Global Ratings lowered to 'A' from 'A+' its long-term issuer credit rating on U.K. social housing provider Karbon Homes Ltd. The outlook is stable.

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

Rationale

Karbon Homes' focus on low-income activities, combined with its moderate levels of debt, help determine our rating on the group. However, we expect that the already-limited economic dynamism of the northeast will deteriorate further as a result of the COVID-19 outbreak, and will continue limiting Karbon Homes' ability to boost its operational and financial performance.

The 'A' rating on Karbon Homes incorporates one notch of uplift from the stand-alone credit profile, reflecting our view of a moderately high likelihood that the entity would receive extraordinary government support in the event of financial distress.

The primary purpose of Karbon Homes is to provide affordable homes, supporting important U.K. government policy objectives. The Regulator of Social Housing (RSH), a government agency, monitors Karbon Homes--along with other regulated social housing providers--in order to promote a viable, efficient, and well-governed social housing sector, and maintains lender confidence and low funding costs across the sector. It is therefore our view that the RSH would step in to try to prevent a default in the sector; a view supported by a track record of RSH's ability and willingness to provide extraordinary support on a timely basis.

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.

One of the strengths of the rating is Karbon Homes' consistent focus on low-income social housing that makes its revenue streams more predictable and ensures its low industry risk. We expect Karbon Homes will further scale down its exposure to market sales, and that revenues from first tranche and outright sales would average around 4% in FY2021-FY2023 (from 10% previously). We view the social housing industry as low risk, predominantly due to its anticyclical nature and strong oversight from the RSH.

However, the concentration of Karbon Homes' activity in the northeast of England, an area of sluggish economic growth and high unemployment, constrains its financial flexibility and has led to steady increases in arrears, estimated to remain above 6% for FY2020. Karbon Homes' average social housing rents are relatively high, at about 76% of market rents. This gap is tighter than in other regions of England, and we expect it would further reduce as social rents increase starting from April 2020.

We chiefly attribute the last two years' increase in arrears to a threefold increase in Universal Credit claimants. However, we anticipate that arrears will remain relatively high, due to the COVID-19's economic impact. On the positive side, vacancy rates have remained very low, even compared with peers and despite slight increases caused by unexpected maintenance of the stock acquisition in May 2018.

While Karbon Homes' management is still working through some of the constraints linked to consolidating strategies of its founding associations, it has kept close surveillance and shifted strategies to adapt to the challenges, not only on its regions of focus, but related to the COVID-19 outbreak.

The management 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.

Following the anticipated economic recession in the U.K. resulting from the COVID-19 outbreak, we forecast that S&P Global Ratings-adjusted EBITDA margin will reduce to 25% for FY2021, down from the 30% estimated for FY2020. This temporary dip in the margin follows our expectation that a share of rents from self-paying tenants will come under pressure. However, we expect that Karbon Homes' flexibility to boost its performance will remain limited, despite being able to increase rents from 2021, EBITDA will be balanced by higher capitalized repairs and anticipated lower margins from nontraditional activities.

Given the anticipated lower EBITDA margins, we expect S&P Global Ratings-adjusted debt to EBITDA to ramp up in FY2021 and FY2022 above 10x; with a particular sharp increase this year to 13x mainly from S&P Global Ratings' estimation of lower forecast EBITDA. While we also estimate that Karbon Homes will have flexibility to scale down its capital spending, it has the capacity to issue its retained bonds and draw on existing bank facilities.

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. We anticipate interest coverage to remain robust, even in FY2021, where lower EBITDA would reduce interest coverage to about 1.8x from 2.2x. Therefore, considering this temporary pressure, we expect adjusted EBITDA to average about 2.1x during FY2021-FY2023.

Environmental, social, and governance (ESG) factors relevant to the rating action are:

- Health and safety

Liquidity

Our assessment of Karbon Homes' very strong liquidity position is based on its very high cash levels, substantial amount of undrawn bank lines, and satisfactory access to capital markets. In our base case over the next 12 months, we estimate sources of about £217 million will cover uses by 2.1x.

Sources of liquidity include:

- Forecast cash generated from continuing operations: £31.8 million;
- Cash and liquid investments: £49.1 million;
- Proceeds from asset sales: £11.5 million; and
- Undrawn, available proportion of committed bank facilities or bank lines maturing beyond the next 12 months: £144 million.

Uses of liquidity include:

- Expected capital expenditure (capex) in the next 12 months: £77.5 million; and
- Interest and principal repayments over the next 12 months: £25.4 million.

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

Outlook

The stable outlook on Karbon Homes signals our view that the estimated weakening EBITDA margins and higher debt will be counterbalanced by Karbon Homes' reliance on more predictable revenue streams. We forecast that EBITDA margins will average about 30% and debt to EBITDA will average 11x through FY2021-FY2023.

We could lower the rating if, contrary to our expectations, EBITDA margins come under increased pressure and persistently drop below 20%, further weighing on the group's debt metrics and liquidity position.

We could upgrade the rating if Karbon Homes proves to be more resilient than we forecast, and manages to increase its EBITDA margins consistently above 30% and overcome regional operational risks, thereby mitigating pressure on the group's financial flexibility.

Key Statistics

Table 1

Karbon Homes Key Statistics

	--Year ended March 31--				
(Mil. £)	**2019a**	**2020e**	**2021bc**	**2022bc**	**2023bc**
Number of units owned or managed	26,834	27,277	27,741	28,378	28,780
Revenue§	124.3	125.6	128.0	136.4	142.8
Share of revenue from sales activities (%)	1.3	4.2	6.4	4.1	3.9
EBITDA§†	38.2	38.0	31.8	40.1	43.6
EBITDA/revenue §†(%)	30.7	30.3	24.8	29.4	30.5
Capital expense†	104.9	67.6	77.5	59.2	32.1
Debt	394.8	374.0	408.1	433.8	425.9
Debt/EBITDA §†(x)	10.3	9.8	12.9	10.8	9.8
Interest expense*	18.0	17.4	18.1	18.5	17.7
EBITDA/interest coverage§†* (x)	2.1	2.2	1.8	2.2	2.5
Cash and liquid assets	74.0	30.5	16.1	16.0	8.0

*Including capitalized interest. §Adjusted for grant amortization. †Adjusted for capitalized repairs. a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Karbon Homes Ratings Score Snapshot

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Strategy and management	3
Asset quality and operational performance	2
Enterprise profile	3
Financial performance	4
Debt profile	3
Liquidity	2
Financial policies	3
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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Global Social Housing Ratings Score Snapshot: December 2019, Dec. 2, 2019
- Global Social Housing Risk Indicators: December 2019, Dec. 2, 2019

Ratings List

Downgraded; Outlook Action

	To	From
Karbon Homes Ltd.		
Issuer Credit Rating	A/Stable/--	A+/Negative/--
Senior Secured	A	A+