S&P Global
Ratings

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Karbon Homes Ltd.

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Karbon Homes Ltd.

Key Rating Factors

Issuer Credit Rating
A/Stable/--

Enterprise profile

Karbon Homes' (Karbon's) commitment to traditional social housing activities offsets higher arrears and void losses compared to national peers.

- Karbon's social housing-focused business model remains a strength, with less volatility in income from exposure to sales than national peers.
- Low regional population growth and a high social-to-market-rent ratio could reduce demand more than for national peers.
- Asset quality also remains a strength, but arrears remain relatively high, and voids have increased in recent years and spiked due to the pandemic.

Financial profile

Weakening margins resulting from increased investments in existing housing stock are offset by Karbon's strong liquidity and debt profile.

- We expect that increased capitalized repairs will suppress S&P Global Ratings-adjusted EBITDA margins to slightly below 30%.
- The £100 million tap of Karbon's senior secured bond in the financial year (FY) ending March 31, 2021, offsets other maturing liabilities, keeping debt-to-EBITDA ratios stable.
- Liquidity will remain strong, with the sources-to-uses ratio increasing.

Rationale

Karbon is a large social housing provider operating in the northeast of England. Its strong focus on traditional social housing activities and stable and experienced management team are notable credit strengths. High levels of liquidity and moderate debt support Karbon's development ambitions. However, increased investments in the existing housing stock will weigh on the group's financial performance. High levels of arrears driven by Universal Credit tenants and a forecast of a weak local economic recovery from the pandemic remain credit weaknesses.

Our rating on Karbon incorporates a one-notch uplift as we consider that the group continues to have a moderately high likelihood of receiving extraordinary support from the U.K. government, working through the Regulator of Social Housing. We base this view on our assessment of Karbon'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 credit support to the social housing sector in certain circumstances.

Following the merger with Byker Community Trust in 2021, Karbon now owns or manages close to 29,000 homes, making it one of the largest social housing providers in the North East and Yorkshire. We expect that Karbon's development plan, to which we apply a haircut, will see over 1,700 new homes built by FY2024, with a spike in development in FY2023 of over 800 homes. A key strength of our rating on Karbon remains the group's consistent focus on affordable social housing that makes its revenue streams more predictable and ensures low industry risk. We expect that Karbon will remain focused on traditional social housing tenures, with minimal outright sales and modest shared-ownership targets in the development plan.

Karbon's gross arrears remain above 6% for FY2021, and we expect them to stay at this level in the short term. This is mainly a result of high arrears among Universal Credit tenants, and the prolonged effect we expect the pandemic to have on the regional economy. Average social housing rents remain relatively high, at about 77% of market rents. This gap is smaller than in other regions of England, and we expect that it may shrink further if annual rent increases outpace the market.

We continue to view Karbon's strategy and management as conservative and aligned with the risks in its areas of operation. The group's internal controls and oversight of financial rules continue to ensure that it meets treasury policies. We maintain our view of Karbon's financial policies as prudent and strong.

We expect Karbon's financial performance from core activities to remain strong. We forecast a small increase in rent losses arising from the pandemic in FY2022 to affect adjusted EBITDA, but we expect these losses to be one-off in nature, as we forecast that the U.K. economy will recover strongly during the year.

Karbon is increasing its capital investment in existing assets, and in FY2022, we forecast that capitalized repairs will increase by more than double FY2020 levels. We understand that this step change in costs relates to a program of energy-efficiency works, alongside committed improvements to housing stock transferred from Byker Community Trust and the cyclical replacement of core components such as kitchens and bathrooms. We forecast that capitalized repairs will remain at the higher level throughout FY2024.

Our assumption of an increase in capitalized repairs will weigh on Karbon's adjusted EBITDA. After adjusting EBITDA for capitalized repairs and amortized grants, we forecast that margins will average 29% up to FY2024, in line with rental income increases from Karbon's new housing developments.

We estimate that Karbon has debt of £475 million following the issuance of a £100 million tap on the senior secured bond in early FY2021. We expect that the debt stock will remain broadly stable, decreasing slightly as facilities mature, and then increasing as Karbon utilizes existing free cash and begins to draw on available bank lines over the next two years. Debt to EBITDA will remain stable at 11x, and interest coverage will remain strong at 2.4x.

Outlook

The stable outlook on Karbon signals our view that the weakening EBITDA margins and higher debt we forecast will be counterbalanced by the group's reliance on more predictable revenue streams. We forecast that Karbon's EBITDA margins will average just below 30% and debt to EBITDA will average 11x through FY2024.

Downside scenario

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

Upside scenario

We could raise the rating on Karbon if it proves more resilient than we forecast, managing to increase its EBITDA margins consistently above 30% and overcome regional operational risks, thereby mitigating the pressure on its financial flexibility.

Liquidity

Karbon's liquidity position remains a rating strength, and reflects very high cash following the bond tap issuance and substantial undrawn bank lines. In our base case for the next 12 months, we estimate that liquidity sources of about £360 million will cover uses by 2.8x. We also continue to view Karbon's access to capital markets as satisfactory.

Sources of liquidity include:

- Our forecast of cash from continuing operations of £54 million;
- Cash and liquid investments of £144 million;
- Proceeds from asset sales of £10 million;
- Ongoing cash injections from the government of £17 million; and
- An undrawn and available proportion of committed bank facilities or bank lines maturing beyond the next 12 months of £135 million.

Uses of liquidity include:

- Our expectation of capital expenditure in the next 12 months of £86 million; and
- Interest and principal repayments over the next 12 months of £40 million.

Environmental, Social, And Governance (ESG)

Karbon's performance on ESG indicators is broadly in line with that of its peers in the social housing sector. As a provider of social housing, Karbon retains a strong focus on its core business of affordable social housing and other low-risk activities. This supports our view that earnings volatility should be limited for Karbon, while the visibility and predictability of future earnings should be solid.

We think that environmental factors could start affecting social housing providers' asset quality as governments, and in turn, regulatory authorities, increase their focus on energy-efficiency and carbon-neutral key performance targets. In the near-to-medium term, this focus could reduce Karbon's profitability, as investments in its asset base would typically need to increase. Over time, however, we foresee a strengthening of asset quality and, ultimately, lower costs, as the homes become more sustainable and energy efficient. We have a neutral view on Karbon's governance and financial policies, and consider them in line with those of most of its peers.

Key Statistics

Table 1

Karbon Homes Ltd.--Key Statistics					
	--Year ended March 31--				
(Mil. £)	**2020a**	**2021e**	**2022bc**	**2023bc**	**2024bc**
Number of units owned or managed	27,197.0	27,644.0	29,939.9	30,653.9	31,098.0
Revenue§	131.0	135.9	138.6	150.7	161.1
Share of revenue from sales activities (%)	4.3	5.2	3.7	2.5	4.6
EBITDA§†	40.1	41.2	34.6	42.0	48.7
EBITDA/revenue §†(%)	30.6	30.4	25.0	27.9	30.2
Capital expense†	68.9	79.1	88.7	58.8	78.3
Debt	382.4	475.6	466.0	464.7	495.5
Debt/EBITDA §†(x)	9.5	11.5	13.5	11.1	10.2
Interest expense*	17.3	15.6	17.3	17.1	17.6
EBITDA/interest coverage §†* (x)	2.3	2.6	2.0	2.5	2.8
Cash and liquid assets	50.9	106.2	29.8	8.0	8.0

§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.

Ratings Score Snapshot

Table 2

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S&P Global Ratings bases its ratings on nonprofit 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 23, 2021
- Building Up Debt: U.K. Social Housing Sector Braces Itself For Borrowing, March 16, 2021
- Global Social Housing Ratings Score Snapshot: December 2020, Dec. 10, 2020
- Global Social Housing Ratings Risk Indicators: December 2020, Dec. 10, 2020
- Outlook 2021: Strong Liquidity Should Help Social Housing Providers Remain Resilient, Dec. 8, 2020
- ESG Industry Report Card: Public And Nonprofit Social Housing Providers Outside The U.S., Aug. 4, 2020

Ratings Detail (As Of May 21, 2021)*	
Karbon Homes Ltd.	
Issuer Credit Rating	A/Stable/--
Senior Secured	A
Issuer Credit Ratings History	
27-May-2020	A/Stable/--
31-Oct-2018	A+/Negative/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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