Research Update:

U.K.-Based Housing Association Karbon Homes Ltd. Rating Affirmed At 'A'; Outlook Stable

May 24, 2022

PRIMARY CREDIT ANALYST

Karin Erlander
London
+ 44 20 7176 3584
karin.erlander
@spglobal.com

SECONDARY CONTACT

Abril A Canizares
London
+ 44 20 7176 0161
abril.canizares
@spglobal.com

Overview

- We understand that U.K. housing association Karbon Homes Ltd. is increasing investments in its existing properties over the next three years while ramping up development of new homes.
- We forecast that this will put negative pressure on Karbon's S&P Global Ratings-adjusted EBITDA margins, non-sales EBITDA interest coverage and debt to non-sales EBITDA.
- It is our view that Karbon has headroom at the current rating level for this projected weakening of its credit metrics.
- We affirmed our 'A' long-term issuer credit rating on Karbon. The outlook is stable.

Rating Action

On May 24, 2022, S&P Global Ratings affirmed its 'A' long-term issuer credit rating on Karbon Homes Ltd. The outlook is stable.

At the same time, we affirmed our issue rating on the £250 million bond issued by Karbon Homes.

Outlook

The stable outlook on Karbon reflects our view that the group's focus on affordable rental units will continue to result in predictable earnings, leading to solid profitability and interest and debt coverage metrics in line with our base case.

Downside scenario

We would consider lowering the ratings on Karbon if investments in the existing asset base or debt-funded development of new homes increased above our current assumptions such that the adjusted EBITDA margins fell below 20% on a sustained basis, while the adjusted non-sales EBITDA interest cover fell below 1.75x or the debt to adjusted non-sales EBITDA ratio increased to more than 15x. We also consider that this would likely put pressure on the group's liquidity position.

Upside scenario

We would consider an upgrade of Karbon if the group's management handles the upcoming investment phase without putting further pressure on the group's credit metrics, or if Karbon's profitability stabilizes at current levels, all else being equal.

Rationale

The affirmation reflects our view that despite a forecast weakening of Karbon's profitability compared with our previous projections, we think that the group has headroom to absorb this pressure. We understand that Karbon has reached a phase of higher investments in its existing properties, underpinned by the group's efforts to accelerate the spend on energy efficiency and fire safety. This includes spending on a recently acquired estate that formed part of the Byker Community Trust that joined the Karbon group on April 1, 2021 and added 1,800 units to the group's portfolio. While these investments will result in weaker adjusted EBITDA margins, we are mindful that the group's focus on affordable homes, which provides predictable and relatively stable earnings, will mitigate some of the pressure such that the adjusted EBITDA margins will remain comfortably above 20% through to the financial year ending March 31, 2025.

Furthermore, over the coming two years, we expect Karbon to increase its development of new homes under its strategic partnership status with Homes England, which provides grant funding, but part of which we project will be debt-funded. However, we consider that Karbon has prudently pre-funded part of this development as it still holds a relatively large amount of cash on its balance sheet following the issuance in June 2020 of the £100 million that was retained on its £250 million bond issue. We therefore project only a moderate increase in debt over the next two years such that its adjusted non-sales EBITDA interest coverage and debt to non-sales EBITDA ratios will remain relatively solid. We project that the group's exposure to sales risk will remain contained, with market sales income at around 5% of the adjusted turnover of the group, further supporting our forecast of relatively stable credit metrics.

We understand that Karbon's subsidiary York Housing, operating around 1,500 homes, has agreed with Leeds and Yorkshire Housing Association to explore a more formal partnership. If agreed, they would operate as new 3,000-home subsidiary of Karbon. While Leeds and Yorkshire Housing Association would bring debt to the group, we think that this would be offset by the additional earnings and consider that the partnership, if agreed, would not have a material impact on Karbon's credit metrics and profitability.

We view the group's strategy as consistent with its operational capacity, further underpinned by the group's experienced management team and solid risk management policies. About 30% of Karbon's development program remains uncommitted, providing flexibility should the profitability weaken beyond our expectations or market conditions deteriorate.

We understand that the increase in investments over the next two years are made with the group's financial policies in mind, to ensure maintenance of solid headroom within lenders' covenants. The group has a strong focus on asset quality, as evidenced by the investments being made and that 80% of the stock already meets Energy Performance Certificate C standards. The group aims to reach 100% by 2030.

Karbon operates in the Northeast of England and has a foothold further south through its subsidiary York Housing Association. The ratio of social and affordable rent to market rent is therefore relatively high at close to 80%, as market rents in this area tend to be lower than in the south of England. Our view is that demand for their properties, comprising close to 30,000 units predominantly for social and affordable rent, remains solid. This is further underpinned by the group's vacancy rates, which are broadly in line with the rest of the English social housing sector at below 2% on average over the past three years, and on an improving trend post a spike during the pandemic.

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 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 step in to try and 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 and think this would also apply to Karbon.

We assess the regulatory framework under which registered providers of social housing in England operate as strong, underpinned by their public policy mandate to provide affordable homes. We also consider that the sector benefits from solid oversight by the Regulator of Social Housing (RSH). These strengths are offset by our view of the relatively low levels of grant funding that the providers in England receive for the development of affordable homes. We consider that social housing providers in England can develop homes for outright sale and use the proceeds as an alternative funding source. However, we think that this exposes them to risks and potential volatility compared with providers in other regions. Providers in England are also subject to negative intervention by the U.K. government in the form of constraints on rent setting or additional spending responsibilities, without adequate additional funding. This weighs on our regulatory framework assessment.

Liquidity

Karbon's liquidity position is very strong, with sources covering uses by 1.9x in the next 12 months. We also consider that Karbon has a satisfactory access to external funding when needed.

Liquidity sources include:

- Cash and cash equivalents of close to £125 million;
- Our forecast of cash from operations of close to £40 million, adding back the noncash cost of sales;
- Proceeds from asset sales of exceeding £5 million;
- Available facilities maturing beyond the next 12 months of close to £105 million; and
- Grant funding and other inflows exceeding £30 million.

Liquidity uses include:

- Capital expenditures, including spending on units for sale, of close to £135 million; and
- Interest and principal repayments of close to £35 million.

Key Statistics

Table 1

Karbon Homes Ltd--Key Statistics

	--Year ended March 31--				
Mil. GBP	**2021a**	**2022e**	**2023bc**	**2024bc**	**2025bc**
Number of units owned or managed	27,542	29,697	30,247	30,712	31,243
Adjusted operating revenue	137.4	140.5	152.2	164.8	168.3
Adjusted EBITDA	43.5	40.0	39.6	41.0	37.8
Non-sales adjusted EBITDA	41.4	37.2	37.1	38.8	36.4
Capital expense	63.2	62.3	132.8	88.2	85.1
Debt	475.5	454.9	464.9	489.9	512.8
Interest expense	18.8	19.1	18.6	18.9	19.5
Adjusted EBITDA/Adjusted operating revenue (%)	31.7	28.5	26.0	24.9	22.4
Debt/Non-sales adjusted EBITDA (x)	11.5	12.2	12.5	12.6	14.1
Non-sales adjusted EBITDA/interest coverage(x)	2.2	1.9	2.0	2.1	1.9

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

	Assessment
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 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 22, 2022
- U.K. Social Housing Sector Borrowing Needs To Rise To Fund Investment In New Homes, March 31, 2022
- Social Housing Outlook 2022: Green Agenda Takes Root In Investment Plans, Nov. 23, 2021
- How U.K. Public Finance Sectors Fare Under Latest Spending Review, Nov. 11, 2021
- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers, June 8, 2021

Ratings List

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