

Research Update:

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

May 17, 2024

Overview

- We project that U.K. social housing provider Karbon Homes Ltd.'s (Karbon's) credit metrics will marginally weaken relative to our previous base-case forecasts, although they remain relatively strong compared to those of peers.
- We anticipate that higher investments in existing properties and a ramp-up of the debt-funded development of new homes will weigh on Karbon's credit metrics.
- We take a positive view of Karbon's ability to maintain relatively stable metrics despite challenges in the sector, thanks to management's solid strategic planning and adherence to conservative financial policies.
- We therefore affirmed our 'A' ratings on Karbon. The outlook remains positive.

Rating Action

On May 17, 2024, S&P Global Ratings affirmed its 'A' long-term issuer credit rating on U.K. social housing provider Karbon Homes Ltd. (Karbon) and its 'A' issue rating on the group's £250 million bond. The outlook is positive.

Outlook

The positive outlook reflects our view that Karbon could outperform our base-case scenario and maintain relatively strong credit metrics compared with those of peers.

Upside scenario

We could raise our ratings on Karbon over the next year if the group's credit metrics strengthen, supported by efficient control of costs and investments in existing homes, all else being equal.

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Downside scenario

We could revise the outlook back to stable if Karbon is unable to incrementally strengthen its key financial metrics. This could be the case if the group's investments in existing and new homes result in its credit metrics performing in line with or weaker than our current projections.

Rationale

The rating affirmation reflects our view that Karbon's key financial metrics will remain strong compared with those of its English housing peers. This is despite Karbon's higher investments in existing homes and higher debt levels as compared to our previous forecast, which will put pressure on the credit metrics in the fiscal year ending March 31, 2025. In our view, Karbon has a strong management team that will uphold internal financial policies and maintain in-built flexibility to mitigate potential external pressures.

Enterprise profile: Support from predictable earnings, limited exposure to sales, and strong management

We think that Karbon benefits from generating most of its earnings in the predictable and countercyclical social housing sector, supported by its solid regional market position and generally cautious approach to sales. The group owns and manages over 32,500 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 evident from its solid operational metrics with the group's vacancy rates on par with those in the sector, averaging roughly 1.8% over the past three years. This is despite the fact that Karbon's average social and affordable rent to market rent ratio in the region where it operates is relatively high compared with other English peers at just over 70%.

Our rating on Karbon reflects our positive view of its management. This is underpinned by the group's detailed strategic plans, conservative financial policies, and prudent risk management. We view management as experienced, and believe that its level of expertise reinforces the maintenance of solid credit metrics despite the headwinds in the sector. We consider that Karbon has a track record of integrating stock transfers of various sizes and complexities without major setbacks. As Karbon executes its pipeline of investment in existing assets and new builds, we believe that management will utilize the flexibility in the development program as needed to contain pressure on the metrics.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (see "Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks," published Oct. 23, 2023, on RatingsDirect).

Financial profile: Increasing investments in existing homes, alongside funding needs for development, have reduced headroom, but Karbon's financials remain sound compared with those of peers

We expect that Karbon's S&P Global Ratings-adjusted EBITDA margins will remain just over 20% over the next three years, due to increased investments in existing stock amid higher demand for repairs and maintenance. We understand that Karbon has brought forward and reprofiled certain

investments based on updated stock data and enhanced requirements, while inflation has also increased costs. Although we forecast a slightly weaker financial performance than our prior expectations, we project that Karbon's adjusted EBITDA margins will improve after fiscal 2025, supported by our assumptions that rental growth will exceed inflation and that Karbon's investments will remain stable, albeit elevated, through to fiscal 2027.

We project that Karbon will hold slightly more debt than in our previous base case, leading to modestly weaker debt metrics. Karbon funded a greater proportion of its development program with debt than we had assumed in fiscal 2024. Starting from a higher debt balance, we forecast that the group will continue to fund higher-than-historical levels of capital expenditure (capex) for development with debt over the next three years, supplementing this with grants, rental revenue from acquired units, and modest sales. Although we now expect Karbon's debt to non-sales adjusted EBITDA ratio closer to 15.0x and non-sales adjusted EBITDA interest coverage averaging 1.8x, we think that the group still maintains a strong debt profile compared to its peers.

We assess Karbon's liquidity position as very strong, with sources covering uses by 1.8x in the next 12 months. This is based on our forecast of liquidity sources of about £348 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 £195 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, and think this would also apply to Karbon.

Key Statistics

Table 1

Karbon Homes Ltd.--Key Statistics

(Mil. £)	--Year ended March 31--				
	2023a	2024e	2025bc	2026bc	2027bc
Number of units owned or managed	31,771	32,800	34,233	34,773	35,297
Adjusted operating revenue	160.5	179.4	199.2	211.8	231.8
Adjusted EBITDA	36.1	40.2	40.6	48.7	52.3
Non-sales adjusted EBITDA	34.2	38.4	39.4	47.5	49.7
Capital expense	97.0	122.0	164.0	130.8	126.5
Debt	479.3	516.5	563.9	641.9	702.6
Interest expense	19.1	20.3	22.9	25.2	28.5
Adjusted EBITDA/adjusted operating revenue (%)	22.5	22.4	20.4	23.0	22.6
Debt/non-sales adjusted EBITDA (x)	14.0	13.5	14.3	13.5	14.1

Table 1

Karbon Homes Ltd.--Key Statistics (cont.)

(Mil. £)	--Year ended March 31--				
	2023a	2024e	2025bc	2026bc	2027bc
Non-sales adjusted EBITDA/interest coverage(x)	1.8	1.9	1.7	1.9	1.7

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 Ltd.--Ratings Score Snapshot

Assessment	Score
Enterprise risk profile	3
Industry risk	2
Regulatory framework	3
Market dependencies	4
Management and Governance	2
Financial risk profile	3
Financial performance	4
Debt profile	2
Liquidity	2
Stand-alone credit profile	a-
Issuer credit rating	A

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

Related Research

- Non-U.S. Social Housing Providers Ratings Score Snapshot: March 2024, March 11, 2024
- Non-U.S. Social Housing Providers Ratings Risk Indicators: March 2024, March 11, 2024
- Non-U.S. Social Housing Providers Ratings History: March 2024, March 11, 2024
- U.K. Social Housing Borrowing 2024: Borrowing capacity remains constrained, March 6, 2024
- European Housing Markets: Forecast Brightens Amid Ongoing Correction, Jan. 25, 2024
- Non-U.S. Social Housing Sector Outlook 2024: At A Turning Point?, Nov. 29, 2023
- Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks, Oct. 23, 2023
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 21, 2023
- U.K. Social Housing Providers' Credit Headroom Could Tighten If The Operating Environment Deteriorates, Oct. 4, 2023
- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022

Ratings List

Ratings Affirmed

Karbon Homes Ltd.

Issuer Credit Rating A/Positive/--

Karbon Homes Ltd.

Senior Secured A

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceld/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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