MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
17 December 2020

RATINGS

Southern Housing Group Limited	
Domicile	United Kingdom
Long Term Rating	A3
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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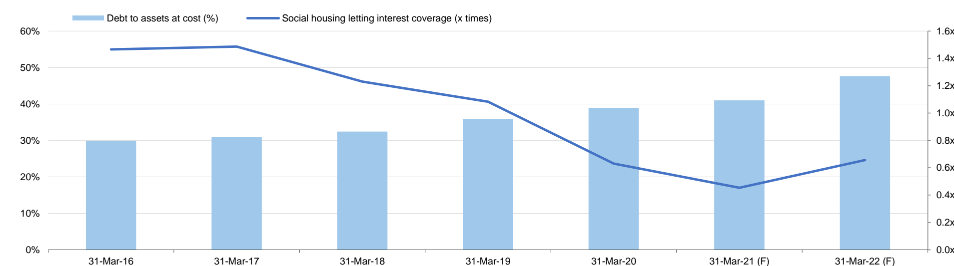
Southern Housing Group Limited

Update following outlook change to negative from stable

Summary

The credit profile of Southern Housing Group Limited (Southern, A3 negative) reflects its large size and strong balance sheet, deteriorating operative performance driving lower interest cover ratios, and growing risk appetite with expected sharp increase in debt, development and market sales risk over the next three years. Southern benefits from the strong regulatory framework governing English housing associations (HAs) and our assessment that there is a strong likelihood that the government of the United Kingdom (UK, Aa3 stable) would intervene in the event that Southern faced acute liquidity stress.

Exhibit 1
Increased debt will weaken Southern's gearing and interest cover ratios
Gearing (%) and social housing lettings interest cover (x times), FY2016-2022



Source: Moody's Investors Service, Southern financial statements and forecasts; (F) = Forecast

Credit strengths

» Large and influential housing association

» Strong balance sheet despite increase in debt, high unencumbered assets

» Supportive institutional framework in England

Credit challenges

» Accelerated growth in debt, capital expenditure and development risk

» Lower income and weaker profitability than previous business plan driving further deterioration in interest cover ratios

» More volatile revenue and operating cash flows due to rise in market sales

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Rating outlook

The negative outlook reflects our view that improvements in operating performance will be challenging given the current economic climate and the group's track record of a sharp decline in operating margin over the last few years. In addition, the group's growing risk appetite driving higher debt and development risk will exert further negative pressure on credit quality and weigh on key ratios, including interest cover and gearing.

Factors that could lead to an upgrade

Upward pressure is unlikely given the negative outlook. Over the medium term, upward pressure could result from a combination of the following: 1) a structurally improved operating margin, especially on the core social housing business, 2) slower debt and interest expense growth boosting interest cover ratios, 3) a lower risk appetite as evidenced by lower capex and a lower proportion of turnover derived from market sales, sustained below 20%.

Factors that could lead to a downgrade

Downward pressure on the ratings would result from higher borrowing than expected, further weakening Southern's debt metrics with gearing (debt to assets at cost) sustained above 55% or debt to revenues sustained above 6.0x. Weaker than expected liquidity with liquidity cover below 0.5x or a failure to deliver on plans to improve operating performance would also exert negative pressure on the rating. Lastly, a dilution in regulatory framework or overall support for the sector from the UK government or a weakening in the UK government's credit quality would exert negative pressure on the rating.

Key indicators

Exhibit 2

Southern Housing Group

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21 (F)	31-Mar-22 (F)
Units under management (no.)	27,221	27,540	27,710	28,334	30,130	31,869	33,259
Operating margin, before interest (%)	32.4	32.3	24.6	26.9	18.5	14.0	20.1
Net capital expenditure as % turnover	24.3	36.0	44.9	54.4	81.6	79.9	181.4
Social housing letting interest coverage (x times)	1.5	1.5	1.2	1.1	0.6	0.5	0.7
Cash flow volatility interest coverage (x times)	2.2	1.5	1.9	0.7	0.5	0.9	1.1
Debt to revenues (x times)	3.8	3.5	3.6	3.6	4.1	4.9	5.7
Debt to assets at cost (%)	29.9	30.9	32.4	35.9	39.0	41.0	47.6

Source: Moody's, Southern

Detailed credit considerations

The credit profile of Southern, as expressed in an A3 negative rating, combines (1) a Baseline Credit Assessment (BCA) for the entity of baa2 and (2) a strong likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

Large and influential housing association

Southern's credit quality benefits from its size as a large and influential London-based housing association. As of year end 2020, Southern had approximately 30,000 homes under management spread across the south of England and a net book value of housing properties of £2.1 billion. It works with other large, London-based housing associations as part of the g15 organisation, to influence public and housing policy.

Southern will benefit from the supportive capital grant environment in England. Through Strategic Partnerships with Homes England and the Greater London Authority, the group has secured government grant for development of new homes; the group has been

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allocated £55 million of capital grant through Homes England. Housing assets will exceed £3.2 billion by fiscal 2023 accounting for newly-built homes.

Strong balance sheet despite increase in debt, high level of unencumbered assets

In order to fund its growth strategy, Southern's drawn debt (net of cash) will nearly double over the next three years weighing on key debt and interest cover metrics. The planned increase in debt, expected to reach £1.7 billion by fiscal 2023 compared to £909 million in fiscal 2020, is representative of a strategic shift in the organisation toward increased debt, development, and market sales risk.

Owing to the group's low historical debt, the group's gearing ratio will remain broadly in line with the A3-rated peer median of 54% (fiscal 2020) despite the sharp increase in debt. Southern's gearing will increase by thirteen percentage points, expected to grow from 39% in fiscal 2020 to 52% by fiscal 2023. By contrast, Southern's gearing averaged 35% over the last four years. Debt to revenues will increase to 5.7x in fiscal 2022 from 4.1x in fiscal 2020 compared to an A3-rated peer median of 4.6x (fiscal 2020).

Southern also benefits from a very strong unencumbered assets position supporting long-term borrowing capacity. The borrowing value of unencumbered assets stood at £1.3 billion at October 2020. Although assets will be used as security to fund growth, the position will remain strong.

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong regulatory framework governing English HAs. The regulator maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and by undertaking biennial In-Depth Assessments (IDAs) for large and complex HAs. In response to the pandemic, the regulator adapted some aspects of its oversight temporarily, for example, extending its liquidity monitoring, briefly pausing the programme of IDAs and delaying regulatory submissions to reduce the operational burden on HAs. The regulator has a strong track record of intervention in cases of mismanagement or financial stress with powers to provide financial assistance and/or make manager appointments where there has been a breach of regulatory standards.

The operating environment for English HAs has improved under more supportive policies for social rent increases and capital grant. Following four years of social rent reductions, HAs now benefit from a return to inflation-linked rent increases from April 2020 for five years. In addition, the government has committed to increased capital grant on more flexible terms for new social housing.

Counterbalancing the improvements, we expect policy to drive increased borrowing and development risk in the sector as it responds to the government's objective to deliver a significant increase in the construction of new homes.

Accelerated growth in debt, capital expenditure and development risk

Although Southern is an experienced developer, the scale of its development ambition under the current strategy constitutes a step change in risk appetite for the organisation which has historically been more risk averse than many of its rated peers. The current business plan incorporates growth of around 1,000 units on average per annum over the next three years across a range of tenures including affordable rent, shared ownership, market rent, and outright sale.

As outlined above, debt will nearly double over the next three years reaching £1.7 billion by fiscal 2023. The group's growth ambition is evident in the accelerated capex, expected to average £315 million per annum over the next three years, compared to a five-year historical average of £64 million. The net capex to revenues ratio is expected to average 100% over the next three years compared to a five-year historical average of 33% and an A3-rated peer median of 19% (fiscal 2018).

The elevated risk of the programme is partially mitigated by the strategy for a significant proportion (approximately 25% over ten years) of growth to come from acquisition of existing homes from other HAs; Southern is expected to complete tenanted acquisitions of 2,300 homes over the next two years. The benefits of acquiring homes are avoiding construction risk, increasing concentration of stock for more efficient services, and strengthening relationships with local authorities through having a larger presence. We also note that the business plan includes the maximum of board-approved risk and growth.

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Lower income and weaker profitability compared to previous business plan driving further weakening in interest cover ratios

Southern's operating margin was significantly lower than expected for fiscal 2020 and will remain well below rated peer medians going forward. The weaker than expected operating performance will impact surpluses, operating cash flows and interest cover ratios and was the primary driver for the downgrade of Southern's BCA in December 2020.

Southern's operating margin of 19% for fiscal 2020 was well below the forecast of 32% and also below the A3-rated peer median of 26% (fiscal 2020), driven by higher building safety costs, impairments and lower market sales margins. In addition to the weak performance for fiscal 2020, the operating margin is expected to be lower going forward under the current business plan compared to last year's, averaging 19% over the next three years compared to a forecast average of 27%.

The weak operating performance and rising debt will negatively impact the group's interest cover ratios which have historically been lower than those of similarly-rated peers due to weaker profitability on the core social housing lettings business. Southern's social housing lettings interest cover (SHLIC) was 0.6x in fiscal 2020, down from 1.2x two years earlier, compared to an A3-rated peer median of 1.2x (fiscal 2020). The SHLIC will remain below 1.0x for the next three years, averaging 0.7x, and one of the weakest of rated HAs.

Cash flow volatility interest cover (CVIC) takes into account fluctuations in operating cash flows driven by market sales activity. On this metric, Southern also underperforms relative to peers with a very low CVIC of 0.6x in fiscal 2020 compared to an A3-rated peer median of 1.6x (fiscal 2020). CVIC is expected to improve as market sales proceeds are realised but will remain weak relative to peers, averaging 1.1x over the next three years.

More volatile revenue and operating cash flows due to rise in market sales

Southern is planning on increasing its market sales exposure over the next few years in order to utilise the profits to partially fund its social housing development. Market sales (first tranche shared ownership and outright sales) will increase from 16% of turnover in fiscal 2020 to 37% by fiscal 2023, a level we deem as very high. Moreover, we note that Southern is increasing its exposure at a time of heightened housing market uncertainty in the UK driven by the pandemic and associated economic fallout.

The increase will make cash flows more procyclical and unpredictable than they have been in the past. Primarily driven by an increase in cash spent on stock for sale, the group's cash flow from operations (CFO) was low compared to historical levels at £40 million in fiscal 2020. CFO is expected to improve gradually reaching £105 million by fiscal 2023, but this is dependent on proceeds from market sales being realised as expected.

Counterbalancing the increased market sales risk is the group's strong track record of performance on market sales. Over the last three years, Southern has averaged a very strong sales margin of 24% on its market sales which reflects both macroeconomic factors and management's experience. Given weaker conditions going forward, the group has moderated its forecasted market sales margins which are expected to average 16% over the next three years.

Southern's liquidity position is adequate and provides some resilience against more volatile operating cash flows. The liquidity coverage ratio, which assesses immediately available liquidity against two years' forward-looking cash need, was 0.8x in fiscal 2020. The liquidity policy is strong and tailored to the organisation's risks, calling for at least 18 months of forecast net expenditure, which includes interest and principal repayments and excludes market sales proceeds.

Extraordinary Support Considerations

The strong level of extraordinary support reflects the wide-ranging powers of redress available to the regulator in cases of financial distress, with the possibility of a facilitated merger or a transfer of engagements. Recent history has shown that the UK government (Aa3 stable) is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support assumption also factors increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more challenging. In addition, our assessment that there is a very high default dependence between (HA) and the UK government reflects their strong financial and operational linkages.

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ESG considerations

How environmental, social and governance risks inform our credit analysis of Southern

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Southern, the materiality of ESG to its credit profile is as follows:

Environmental considerations are not material to Southern's credit profile. In line with the rest of the UK, the sector's main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by county and national authorities, and therefore the financial burden of adapting to increased flood risk will not fall on individual housing associations.

Social risks are material to Southern's credit profile. In particular, the sector is exposed to risks stemming from socially-driven policy agendas affecting social rents, benefits and capital grants in addition to the impact of demographic trends on demand which are captured in our assessment of the operating environment. We expect the coronavirus pandemic to cause ongoing operational disruption for housing associations. Southern's market sales performance and income will continue to be adversely affected by weaker economic conditions in the UK, driven by the pandemic. HAs are also impacted by customer relations and product quality. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards with many HAs planning on increasing spending on the quality of their existing stock. Southern's operating margin will lower in part due to higher building and fire safety expenses.

Governance considerations are also material to HAs' credit profiles and are captured in our assessment of governance and management. Southern's financial management is weaker than peers due to its growing risk appetite with rising debt and market sales exposure combined with its operating performance expected to remain among the lowest of rated housing associations.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

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Rating methodology and scorecard factors

The assigned BCA of baa2 is close to the scorecard suggested BCA of baa3.

The methodologies used in this rating were European Social Housing Providers, published in April 2018 and Government Related Issuers, published in February 2020.

Exhibit 3
Southern Housing Group, 31 March 2020

Southern Housing Group			
Baseline Credit Assessment	Sub-factor Weighting	Value	Score
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	30,130	a
Factor 3: Financial Performance			
Operating Margin	5%	18.5%	baa
Social Housing Letting Interest Coverage	10%	0.6x	b
Cash-Flow Volatility Interest Coverage	10%	0.5x	b
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	4.1x	ba
Debt to Assets	10%	39.0%	baa
Liquidity Coverage	10%	0.8x	baa
Factor 5: Management and Governance			
Financial Management	10%	ba	ba
Investment and Debt Management	10%	baa	baa
Suggested BCA			**baa3**

Source: Moody's, Southern

Ratings

Exhibit 4

Category	Moody's Rating
SOUTHERN HOUSING GROUP LIMITED	
Outlook	Negative
Issuer Rating -Dom Curr	A3
Senior Secured -Dom Curr	A3

Source: Moody's Investors Service

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