Research Update:

U.K. Housing Provider Metropolitan Thames Valley Housing 'A-' Rating Affirmed; Outlook Stable

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Overview

- U.K. housing provider Metropolitan Thames Valley Housing (MTVH) has reduced its sales appetite in its latest business plan, but we still expect that the group's development-for-sale activities (including joint ventures) will exceed one-third of total revenues.
- Our view of MTVH's creditworthiness balances its solid liquidity and strong demand for its social housing business, against its significant exposure to development-for-sale activities and its higher debt metrics.
- We are affirming our 'A-' long-term issuer credit rating on MTVH.
- The stable outlook reflects our view that the core social housing business will continue to mitigate volatility and risks from the group's development-for-sale activities, and that MTVH will benefit from a moderately high likelihood of support from the U.K. government.

Rating Action

On Dec. 19, 2019, S&P Global Ratings affirmed its 'A-' long-term issuer credit rating on U.K.-based housing provider Metropolitan Thames Valley Housing (MTVH). The outlook is stable.

We are also assigning our 'A-' long-term issuer credit rating to Metropolitan Housing Trust Ltd., as we view it as a core subsidiary of MTVH.

At the same time, we affirmed our long-term issue rating on Metropolitan Funding PLC's £250 million senior secured bond at 'A-'. Metropolitan Funding PLC was set up for the sole purpose of issuing bonds and lending the proceeds to the group, and we view it as a core subsidiary of MTVH.

Rationale

The affirmation reflects our expectation that MTVH will continue to focus on delivering its significant sales development program. The group has slightly revised down its sales appetite in its latest business plan, now aiming to keep its exposure to sales activities (including joint ventures [JVs]) below 40% of total revenues, down from 50% last year. The updated development plan for MTVH aims to deliver around 6,700 units (including development through JVs) over the next five years, of which 44% will be for shared ownership sales, 36% for social housing rental tenures, and the remaining 20% for outright sales. This is a slight decrease from the 8,800 units expected in last year's business plan.

We assigned one or more of the credit ratings mentioned in this article by deviating from S&P Global Ratings' published criteria. We think that significant exposure to sales activities limits visibility and predictability of future earnings in a way not typically seen with a traditional housing association providing mainly social rent properties. In our view, exposure to sales activities will also reduce the ability to withstand external risks. We therefore deviate from our "Methodology For Rating Public And Nonprofit Social Housing Providers," published on Dec. 17, 2014, when assessing the industry risk for housing associations that generate more than one third of their revenues from market sales. We do this by blending S&P Global Ratings' industry risk assessment for social housing providers (2), and that for homebuilders and real estate developers (4) in line with our "Key Credit Factors For The Homebuilder And Real Estate Developer Industry," criteria published on Feb. 3, 2014. For more information see "Credit FAQ: How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers," published on Aug. 6, 2018.

MTVH's creditworthiness benefits, in our view, from a moderately high likelihood of extraordinary support from the U.K. government, through the Regulator of Social Housing, in the event of financial distress. The 'A-' rating on MTVH is therefore one notch higher than its stand-alone credit profile. Our view of a moderately high likelihood of extraordinary government support is based on MTVH's important role for the U.K. government and its public policy mandate. It is also based on the group's strong link with the U.K. government, demonstrated by the government's track record of providing credit support to the sector in certain circumstances.

In our current base case, we have factored in a slight reduction in sales exposure, but we still forecast that first-tranche shared-ownership sales and outright sales (including JVs) will structurally account for more than one-third of the group's revenues, exposing MTVH to cyclical and more volatile income sources. Although we think that management--which combines talent from Metropolitan Housing Trust and Thames Valley Housing--is highly skilled and has the capabilities to grow at such a scale, we consider that the overall program remains ambitious. We think it will continue to expose the business to more cyclical risk from the housing market, and consequently we have factored some slippage and sales delays into our base case compared to MTVH management estimates.

We expect the merger between Thames Valley Housing and Metropolitan Housing Trust to be mostly completed by March 2020, with the combined group sustaining a strong enterprise profile thanks to the stability and high demand observed for its traditional social housing asset base. It has a significant geographic footprint in the U.K., with a large stock of more than 50,000 social housing units. The main focus of operations and development is London, but there are large concentrations in the South East, East Midlands, and the East of England. The London area benefits from stronger population growth than the national average, along with higher market rent than social and affordable rent, but the group's economic fundamentals are slightly weighed down by its activities in other geographic locations.

The group is characterized by extremely strong asset quality, supported by its relatively young portfolio with an average age of around 33 years. All units comply with Decent Homes Standards. The group maintains a low level of vacancies, which stood at 1.2% as of the end of financial year (FY) 2019. Gross arrears remain higher than those of peers nationwide, but are in line with MTVH's rated peers operating in London.

In line with sector trends, the group is carrying out intrusive tests and surveys across all its estates, with a focus on fire safety risk and cladding. Although we view these investments as a positive factor for asset quality, we expect that they will also put pressure on the group's profitability, as capitalized repairs will continue to increase over the forecast horizon. There is still uncertainty around the total cost impact linked to fire safety works, as it will depend on the outcome of the surveys and on any new regulation regarding building safety risk.

We continue to expect subdued financial performance for MTVH compared to the historical performance of Metropolitan Housing Trust and Thames Valley Housing. We expect in our base case that adjusted EBITDA margins will remain below 30%, driven by increasing levels of capitalized repairs and a high proportion of revenues coming from development-for-sale activities, which exhibit lower margins. MTVH's traditional social housing rental tenures show operating margins of around 35% over our forecast period, while we expect its development-for-sale activities to have operating margins of just 15%. Although we expect that margins will remain below 30% over our forecast horizon, reflecting higher capitalized repairs linked to fire safety investments combined with the increasing role of lower-margin development-for-sale activities, we foresee the group's financial performance strengthening beyond FY2021 as the supportive CPI+1% rent settlement benefits the group's rental activities.

Our expectation is that MTVH's development efforts will remain constant over the next two years and increase in FY2022, which will require additional funding beyond the group's current committed facilities. This reflects our expectation of higher capital expenditure (capex) in FY2022, although sales exposure in that year will remain subdued due to the timing gap between the start of the development and the completion and sale of the units.

Lower anticipated margins along with higher funding needs will impact MTVH's debt sustainability metrics. We forecast an increase to about £2.4 billion in nominal debt in FY2022 from £1.9 billion in FY2019. This reflects our expectations that the entity will draw on its existing facilities to finance parts of its capital program, with capex also being funded through sales receipts. We expect debt to EBITDA to average about 17.9x in FY2020-2022, as EBITDA margins remain subdued and the group increases its borrowings. Our assessment of MTVH's financial policies is constrained by its higher tolerance for leverage than peers. We continue to take into account that income from non-sale activities will just cover interest costs through 2022 (1.1x on average for 2020-2022).

Liquidity

We view MTVH's very strong liquidity position as a credit strength. We expect sources of liquidity for the group to exceed planned uses by around 1.9x over the next 12 months, mainly supported by its very large undrawn bank facilities.

This very solid coverage incorporates about £546 million of committed and secured undrawn short-term facilities, about £125 million of cash flow from operations (before interest), £119 million of cash, and about £104 million of proceeds from asset sales.

MTVH is set to use these liquid assets to finance its large capital development program, with around £205 million of capex related to fixed assets, close to £196 million of interest and principal payments due over the next 12 months, and £72 million in grants to be repaid to GLA and Homes England related to past land acquisitions and ongoing repayments of expired grants.

We view MTVH's access to external liquidity as satisfactory given its ready access to bank funding but limited track record of issuance in the capital markets.

Outlook

The stable outlook reflects our expectation that MTVH's core social housing lettings business will continue to mitigate the volatility and risks linked to the group's development-for-sale activities. It also reflects our view that MTVH will continue to benefit from a moderately high likelihood of support from the U.K. government.

Downside scenario

We could lower the ratings on MTVH if we observed a deterioration of its debt and liquidity profile beyond our current expectations, especially should the group's EBITDA from non-sales activities not cover its interest payments. This could occur if the group's development-for-sale activities over the next few years put more pressure than we expect on its liquidity position or funding needs. We could also lower the ratings if we revised down our assessment of the likelihood of support that MTVH receives from the U.K. government through the Regulator of Social Housing.

Upside scenario

We could raise the ratings if we observed an improvement in financial performance, with adjusted EBITDA margins structurally above 30% of revenues, along with contained exposure to sales activity below one-third of total revenues. Under such a scenario, we would expect MTVH to maintain its very strong liquidity position and balanced debt profile.

Table 1

Metropolitan Thames Valley Housing Selected Financial Indicators

	--Year ended March 31--				
(Mil. £)	**2018a**	**2019a**	**2020e**	**2021bc**	**2022bc**
Number of units owned or managed	51,462	51,966	52,816	53,753	54,445
Revenue§	409.3	400.5	489.4	444.3	404.5
Share of revenue from sales activities (%)	23.2	20.3	33.5	22.8	11.1
EBITDA§†	121.2	102.6	119.7	125.2	124.6
EBITDA/revenue §†(%)	29.6	25.6	24.5	28.2	30.8
Capital expense†	205.0	222.1	199.3	206.9	416.4
Debt	1,755.1	1,986.1	2,086.6	2,179.4	2,407.5
Debt/EBITDA §†(x)	14.5	19.4	17.4	17.4	19.3
Interest expense*	79.3	86.9	90.1	94.6	101.7
EBITDA/interest coverage§†* (x)	1.5	1.2	1.3	1.3	1.2
Cash and liquid assets	158.5	223.0	52.8	102.4	63.6

§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

Metropolitan Thames Valley Housing Ratings Score Snapshot

Industry risk	3
Economic fundamentals and market dependencies	2
Strategy and management	3
Asset quality and operational performance	1
Enterprise profile	3
Financial performance	5
Debt profile	3
Liquidity	2
Financial policies	3
Financial profile	4

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: Group Rating Methodology, July 1, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 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

- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Global Social Housing Risk Indicators: December 2019, Dec. 2, 2019
- Global Social Housing Ratings Score Snapshot: December 2019, Dec. 2, 2019
- Outlook 2020: Social Housing Providers Face Pressure From Rising Demand And Maintenance Backlog, Nov. 25, 2019
- United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019

Ratings List

Metropolitan Thames Valley Housing	
Ratings Affirmed	
Metropolitan Thames Valley Housing	
Issuer Credit Rating	A-/Stable/--
Metropolitan Funding PLC	
Senior Secured	A-
New Rating	
Metropolitan Housing Trust Ltd.	
Issuer Credit Rating	A-/Stable/--