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Research Update:

U.K. Social Housing Provider Stonewater Ltd. 'A+' Rating Affirmed; Outlook Stable

July 15, 2020

Overview

- Stonewater Ltd.'s continued expansion through social housing development and stock acquisition should outpace homes lost to government schemes and steadily increase its housing stock, while operating efficiencies and rent increases will help improve the company's financial position after the COVID-19 pandemic.
- At the same time, funding activities in recent months have resulted in an improved liquidity position that mitigates the planned higher capital expenditure over the outlook period.
- We are therefore affirming our long-term issuer credit rating on Stonewater at 'A+'.
- The stable outlook indicates our expectation that Stonewater will manage its development program in a risk-appropriate manner, such that financial performance improves in line with our base case.

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Rating Action

On July 15, 2020, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K-based social housing provider Stonewater Ltd. The outlook is stable.

We also affirmed our 'A+' issue rating on the bond issued by Stonewater Funding PLC (SF). SF was set up for the sole purpose of issuing bonds and lending the proceeds to Stonewater, and we view it as a core subsidiary.

Rationale

We affirmed the rating as we consider that Stonewater's revised development and sales plan and recent funding activity to improve its liquidity position will help navigate the uncertainty caused by the COVID-19 pandemic. In March 2020, Stonewater took advantage of its economies of scale and purchased 731 homes located in Wiltshire, Berkshire, and Oxfordshire from Southern Housing Group for approximately £46 million, a cheaper cost per unit than developing its own properties. We still expect Stonewater will develop about 3,300 homes by March 31, 2023, which will require an additional £178 million in funding during the financial year (FY) ending March 31, 2021, the majority of which is already secured.

In our base case, we assume that Stonewater will suffer some rental losses in its general needs and affordable housing operations because of the COVID-19 pandemic. As such and excluding surplus from asset sales, we expect S&P Global Ratings-adjusted EBITDA margins to bottom out at 30% in FY2022. That said, we expect stress to be contained in FY2022 since a more-favorable rent policy, allowing increases of consumer price index (CPI) plus 1%, combined with a growing asset base, should see margins trend above 30% again in FY2023.

Like other registered English social housing associations, we believe there is a moderately high likelihood that Stonewater would receive extraordinary support in case of financial distress. This provides a one-notch uplift from the stand-alone credit profile (SACP). Stonewater's primary purpose is to provide affordable homes, supporting important policy objectives of the U.K. government. We consider that the Regulator of Social Housing (RSH), a government agency, regulates Stonewater to promote a viable, efficient, and well-governed social housing sector, and maintain lender confidence and low funding costs across the sector. It is therefore our view that the RSH would step in to prevent a default in the sector, based on its record of being willing and able to provide extraordinary support on a timely basis.

Stonewater benefits from the countercyclical nature of its traditional social housing business with low competition. The group was formed five years ago through the merger of Raglan and Jephson. It has an operating footprint expanding across England, but mainly in the Midlands, East, and South. We view Stonewater's access to this large demographic and economic mix as a positive factor. Population growth across England remains slow but steady at 0.5%. This results in good affordability and steady demand for social housing, in our view. We note that Stonewater's social rent levels have increased to 74% of the market rate, which is higher than its peers.

Stonewater receives about 85% of its revenue from traditional social activities, which we view as stable and not subject to market risk. Stonewater also generates income by providing third party management and maintenance services with 35 homes under contract, which is expected to increase as Stonewater is the largest management provider for Legal & General Affordable Homes. The property portfolio is maintained to regulatory standards, is fairly new, with an average age of 27 and has three-year average voids of 1.5% indicating extremely strong asset quality. However, we observe that gross arrears have increased and are approaching 9% of rent and service charge receivable before provisions as of June 2020 and apply a negative adjustment. Management is implementing proactive analysis of rental arrears to ensure tenancies are sustained while the government implements universal credit measures and also budgeting for higher bad debt allowance given COVID-19.

As part of its long term strategy to deliver affordable homes, Stonewater is a development partner of Homes England, the regulatory arm of the government overseeing the allocation of grants to registered housing providers. Stonewater's latest development program aims to average around 1,000 units per year and then increase to 1,500 units per year starting in FY 2022 with a focus on high demand two and three bedroom homes utilizing a design philosophy based on light, energy efficiency and flexible space. Management is conscious of their carbon footprint, disposing of voided units that no longer meet tenant demand and making homes more eco-friendly.

As such we anticipate over £55 million of capital expenditure for maintenance and £600 million for new development in 2021-2023. Following the development program, we therefore forecast £350 million of additional debt during that period, with the adjusted debt-to-EBITDA ratio averaging 18x and adjusted EBITDA interest coverage averaging 1.6x. As part of its affordable housing program, Stonewater also conducts shared ownership sales. We forecast Stonewater will build and sell a first tranche of nearly 1,000 shared ownership homes over the next three years.

We expect Stonewater to demonstrate a solid financial performance, with an S&P Global Ratings-adjusted five-year average EBITDA margin of 33%, despite a temporary hit on revenue from general needs arrears and reduced market operations. We think that EBITDA will be supported by efficiencies and cost savings from the digitalization program. We project that income from first tranche sales will increase to over 15% of turnover by March 2023. We believe this increase adds potential volatility to Stonewater's revenue, given the uncertainties of earnings from market-related sales and the lower margins earned when compared with social and affordable rental margins.

We believe there is a comprehensive risk management, treasury, and governance framework in place to safeguard the social housing operations and assets. Stonewater's management team is well established and stable, with the right skills and experience to deliver the company's strategic objectives over the next three years, given its cautious approach to open market sales.

Liquidity

We think Stonewater has a strong overall liquidity position and has good access to external liquidity having secured funding from 10 lenders and recently completed a £75 million private placement with U.S. investors. We expect Stonewater's liquidity position to stay strong over the next 12 months, with sources of liquidity of about £544 million covering uses of about £231 million, by 2.35x.

We project that Stonewater will have the following sources of liquidity:

- Adjusted EBITDA as a proxy for cash flow from operations exceeding of £59 million;
- About £151 million of cash and cash equivalents;
- Asset sales proceeds of £9 million;
- Undrawn committed facilities of more than £310 million; and
- About £17 million of government grants.

We project the following liquidity uses:

- Adjusted capital expenditure of more than £171 million; and
- About £60 million of interest and principal repayments.

Outlook

The stable outlook indicates that Stonewater will continue to benefit from its strong asset quality and operations, and that management will succeed in implementing its development plan such that its financial performance and debt leverage will recover to pre-pandemic levels after FY2022.

Downside scenario

We could lower the rating if the COVID-19 pandemic led to materially weaker financial performance, with EBITDA margins consistently below 30% and a debt burden above 20x. Failure to contain expenses, leading to considerably lower-than-anticipated margins, could result in deterioration of liquidity metrics.

A negative rating action could also occur if we revised the likelihood of support provided by the

RSH or lowered the rating on the U.K. government.

Upside scenario

We could raise the rating if Stonewater's financial profile improved, for example, because of a reduction in nontraditional activities, so that revenue from market sale activities remains below 15% of total revenue throughout the forecast period. It could also improve if the level of gross rental debtors falls below peers' and adjusted EBITDA to revenue improves to above 40%.

Key Statistics

Table 1

Stonewater Limited Key Statistics

	--Year ended March 31--				
(Mil. £)	**2019a**	**2020e**	**2021bc**	**2022bc**	**2023bc**
Number of units owned or managed	32,354	31,416	31,951	33,117	34,494
Revenue§	183.7	182.0	173.5	207.4	240.3
Share of revenue from sales activities (%)	10.9	9.2	8.9	14.9	21.1
EBITDA§†	64.8	64.2	56.3	62.2	76.2
EBITDA/revenue §†(%)	35.3	35.3	32.4	30.0	31.7
Capital expense†	102.6	142.6	152.7	203.8	185.2
Debt	918.0	966.1	1,124.1	1,139.1	1,231.0
Debt/EBITDA §†(x)	14.2	15.0	20.0	18.3	16.2
Interest expense*	36.2	33.9	37.4	40.3	42.0
EBITDA/interest coverage§†* (x)	1.8	1.9	1.5	1.5	1.8
Cash and liquid assets	106.8	139.2	197.7	103.8	107.9

§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. N.A.--Not available.

Ratings Score Snapshot

Table 2

Stonewater Ltd. Ratings Score Snapshot

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

Table 2

Stonewater Ltd. Ratings Score Snapshot (cont.)

Financial policies	3
Financial profile	3

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
- 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

- Global Social Housing Ratings Risk Indicators: July 2020, July 14, 2020
- Global Social Housing Ratings Score Snapshot: July 2020, July 14, 2020
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019

Ratings List

Ratings Affirmed	
Stonewater Ltd.	
Issuer Credit Rating	A+/Stable/--
Stonewater Funding PLC	
Senior Secured	A+