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Research Update:

U.K.-Based Metropolitan Housing Trust Ratings Lowered To 'A-' On Higher Sales Risk; Outlook Now Stable

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Overview

- We expect Metropolitan to continue expanding toward market-related activities, such that revenues from this more volatile and less profitable sector account for more than a third of total revenues through 2021.
- Metropolitan has decided to budget additional spending to improve the condition and safety of its stock, which will likely keep income from social lettings below annual interest spending for the next two-to-three years.
- In our view, this will put pressure on the group's financial performance and reduce the entity's capacity to withstand external shocks.
- We are therefore lowering our long-term rating on Metropolitan to 'A-' from 'A+'.
- The stable outlook reflects our expectation that the underlying social housing business will continue to mitigate risks from increased exposure to non-core business, and that Metropolitan continue to benefit from a moderately high likelihood of support from the U.K. government. Based on our first consolidation exercise, we also believe that Metropolitan's likely partnership with Thames Valley would not materially affect ratings.

Rating Action

On July 24, 2018, S&P Global Ratings lowered to 'A-' from 'A+' its long-term issuer credit rating on U.K-based Metropolitan Housing Trust (Metropolitan). The outlook is stable.

We also lowered our long-term issue rating on Metropolitan Funding PLC's £250 million senior secured bond to 'A-' from 'A+'. Metropolitan Funding was set up for the sole purpose of issuing bonds and lending the proceeds to Metropolitan, and we view it as a core subsidiary of the Metropolitan group.

Rationale

The downgrade reflects our base-case expectation that Metropolitan will maintain its significant sales program, such that first tranche shared-ownership sales and outright sales will account for more than a third of the group's revenue on average over our forecast period financial year (FY) ending March 31 2019-FY2021. We believe that the group's higher exposure to more volatile business will stretch its financial risk position and reduce the headroom to withstand external risks. We recognize that this is a structural trend in the industry to mitigate a reduction in government grant funding. However, in our view, it elevates risk for Metropolitan by exposing the business to cyclical and potentially more volatile income sources. However, the company is still able to maintain strong liquidity and sustain its moderately high debt burden thanks to the stability and high demand observed for its traditional social housing activities.

Moreover, Metropolitan'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. Therefore, the rating on Metropolitan is one notch higher than its stand-alone credit profile. Our view of a moderately high likelihood of extraordinary government support is based on our assessment of Metropolitan's important role for the U.K. government and its public policy mandate. It is also based on Metropolitan's strong link with the U.K. government, demonstrated by the government's track record of providing credit support in certain circumstances.

We believe that the industry risk for English social housing entities with a high and mounting reliance on sales activities, such as Metropolitan, has heightened. With the reduction in grant funding and the detrimental effect from welfare reforms, Metropolitan has in recent years gradually expanded into market-related activities to cross-subsidize affordable and social housing development. Although Metropolitan remains a non-profit provider of social housing, these activities now form a solid core business to the group.

This shift in business focus reflects a broader sector-wide shift toward market-based activities, particularly outright sales and first-tranche shared ownership sales, which in our opinion elevate risk profiles in underlying businesses. Unlike traditional rental activities, these expose housing associations to the cyclicality in the residential property development sector. The growth in this sector is less predictable than in social housing given the significantly higher level of competition.

In our view, consumer confidence, disposable income, employment levels and growth, as well as interest rates and the availability of mortgage loans would ultimately drive demand for Metropolitan's properties for sale, which heighten revenue and earnings volatility. Additionally, high variability in sales levels and property valuations, as manifested by recent fluctuations in U.K. housing prices, render social housing groups vulnerable to business cycle blips.

Metropolitan benefits, however, from strong demand for social housing in London-- Metropolitan's prime area of operations. The London area benefits from stronger population growth than the national average along with higher market rent than the social and affordable rent. Nonetheless, as the group will expand its activities out of the London area and in regions marked by weaker economic and demographic indicators (e.g. the East Midlands and the East of England), economic fundamentals will weaken in our view. The group has managed to reduce vacancies to below 1.5% of net rental income including service charge over 2017-2018 as well as current arrears that stood below 4% as of FY-end 2018.

The increasing importance of the development for sale along with the continued negative impact of the sector's rents cuts will result the group's financial performance weakening. We forecast Metropolitan's adjusted EBITDA margin will average about 20% of revenue over 2019-2021, down from 25% in our previous base case. The sharp decrease is, however, partly due to a significant increase in maintenance and repair work planned in 2019-2020, which is weighing on margins. Following the Grenfell Tower tragedy in 2017, Metropolitan has decided to budget additional expense to improve the condition and safety of its stock.

The lower anticipated margins, in combination with nominal debt increase to fund development activities, will lift the Metropolitan's debt burden. We expect debt to EBITDA to average about 18x in 2019-2021, up from 15x in 2017-2018.

Our assessment of Metropolitan's financial policies are hampered by its higher tolerance of leverage than peers. Also, we negatively factored in that income from social housing lettings will be short of covering interest costs through 2021 (0.9x on average for 2019-2021). We view positively, however, that the group has limited exposure to interest rate fluctuations and a smooth debt maturity profile.

Liquidity

We consider Metropolitan's liquidity position as strong, primarily thanks to ample undrawn liquidity facilities, moderate cash levels, low debt repayments, and satisfactory access to external liquidity. In our base case, sources of cash will cover uses of by about 1.6x over the next 12 months. This is however somewhat lower than in our previous review (1.8x), but in line with our expectations, largely due to drawings of existing liquidity facilities and somewhat lower cash levels compared with last year.

Liquidity sources for the next 12 months include:

- About £59 million of cash expected from internally generated cash flow over the next 12 months;
- Cash and liquid investments of £45 million;
- Proceeds from asset sales of £59 million;
- Undrawn committed bank facilities of £122 million; and
- Undrawn bond proceeds of £100 million.

Liquidity uses include:

- Expected capital expenditure related to fixed assets of £146 million;
- Interest and principal payments due over the next 12 months of £79 million; and
- Governments grants to be repaid of £22 million.

Outlook

The stable outlook reflects our expectation that the underlying social housing business will continue to mitigate risks from increased exposure to non-core business, and that Metropolitan will continue to benefit from a moderately high likelihood of support from the U.K. government. Also, based on our first consolidation exercise, we believe that Metropolitan's likely partnership with Thames Valley would not materially affect the ratings.

We could lower the rating if Metropolitan's financial performance and debt profile deteriorated further, beyond our current expectations. This could occur if Metropolitan's plan to increase its exposure to market sales and presence outside of London accentuated pressure on margins and liquidity more than our base-case projection.

We could also lower the rating if we believed the likelihood of timely extraordinary support from the U.K. government to Metropolitan had decreased.

We could raise the rating if Metropolitan reduced its exposure to sales significantly, such that revenues coming from market-related activities decreased compare with our base case, and we observed structural improvement in financial performance with margins returning to structurally close to 30% of revenues while Metropolitan's core social housing business cover interest expense at materially more than 1x.

Key Statistics

Table 1

Metropolitan Housing Trust Ltd. Selected Indicators

	--Year ended March 31--				
(Mil. £)	**2017a**	**2018e**	**2019bc**	**2020bc**	**2021bc**
Number of units owned or managed	37,505	38,046	41,037	41,235	41,520
Vacancy rates (% of total rent and service charge)	1.3	0.9	N.A.	N.A.	N.A.
Arrears (% of net rental income)*	4.0	3.9	N.A.	N.A.	N.A.
Revenue§	260.8	283.2	320.0	384.6	373.5
Share of revenue from nontraditional activities (%)	25.5	30.1	37.6	47.1	43.0
EBITDA†	81.4	70.4	58.5	78.0	77.8
EBITDA/revenue (%)	31.2	24.9	18.3	20.3	20.8
Interest expense	53.1	53.6	55.1	56.6	58.8
Debt/EBITDA (x)	12.9	16.2	21.1	16.2	17.7

Table 1

Metropolitan Housing Trust Ltd. Selected Indicators (cont.)					
	--Year ended March 31--				
(Mil. £)	**2017a**	**2018e**	**2019bc**	**2020bc**	**2021bc**
EBITDA/interest coverage** (x)	1.5	1.3	1.1	1.4	1.3
Capital expense	133.4	127.5	105.0	106.1	174.4
Debt	1,050.1	1,143.5	1,237.7	1,260.6	1,372.6
Housing properties (according to balance sheet valuation)	2,851.2	2,989.6	3,054.2	3,089.2	3,198.3
Loan to value of properties (%)	36.8	38.2	40.5	40.8	42.9
Cash and liquid assets	104.2	88.6	80.8	89.9	54.9

§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

Metropolitan Housing Trust Ltd. 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	3
Financial policies	3
Financial profile	4

S&P Global Ratings' analysis of social housing providers' creditworthiness rests on our scoring of eight key rating factors: (i) industry risk; (ii) economic fundamentals and market dependencies; (iii) strategy and management; (iv) asset quality; (v) financial performance; (vi) debt profile; (vii) liquidity; and (viii) financial policies. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published Dec. 17, 2014, and "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015, detail how we derive and combine the scores, and then determine each social housing provider's stand-alone credit profile and the issuer credit rating. In accordance with S&P Global Ratings'public and nonprofit social housing providers methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating, the committee can make use of the flexibility afforded by paragraphs 12-17 of "Methodology For Rating Public And Nonprofit Social Housing Providers."

Related Criteria

- 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: Group Rating Methodology, Nov. 19, 2013
- 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

- U.K. Housing Association Guinness Partnership Rating Lowered To 'A' On Higher Sales And Volatility Risk; Outlook Stable, July 24, 2018
- U.K.-Based Social Housing Association GreenSquare Group Ltd. Rating Lowered To 'A-' On Higher Sales Risk; Outlook Stable, June 20, 2018
- Places for People Group Rating Lowered To 'A-' On Increased Exposure To Market Sales; Outlook Now Stable, June 20, 2018
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018
- U.K. Social Housing Providers To Borrow £12 Billion Of New Debt By 2020, Total Debt to Reach £89 Billion, March 7, 2018
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 27, 2018
- New Rent Policy Brings Relief, But No Big Boost To The Credit Standing Of U.K. Housing Associations, Jan. 31, 2018
- Global Social Housing Risk Indicators, Jan. 30, 2018
- U.K. Social Housing Scenario Analysis: What Could Happen To Ratings In A Market Downturn? Sept. 25, 2017
- U.K.-Based Metropolitan Housing Trust 'A+' Ratings Affirmed; Outlook Remains Negative, July 21, 2017

Ratings List

Downgraded; Outlook Action

	To	From
Metropolitan Housing Trust Ltd.		
Issuer Credit Rating	A-/Stable/--	A+/Negative/--
Metropolitan Funding PLC		
Senior Secured (1)	A-	A+

(1) Co-issued by Metropolitan Housing Trust Ltd. and Metropolitan Funding PLC.

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.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.