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Research Update:

U.K.-Based Metropolitan Housing Trust 'A+' Ratings Affirmed; Outlook Remains Negative

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Table Of Contents

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Overview

- We now foresee Metropolitan Housing Trust's (Metropolitan's) adjusted EBITDA margin at less than 30% in our updated base case for 2018-2020, resulting from its expansion into development for private sales and the continued negative impact stemming from rent cuts and mounting costs linked to uncertainty surrounding Brexit negotiations.
- Consequently, we now regard Metropolitan's financial risk profile as weaker than previously and have revised down our stand-alone credit profile (SACP) for the group to 'a' from 'a+'.
- Metropolitan continues to benefit from a moderately high likelihood of support from the U.K. government, which we factor into our rating with a one-notch uplift from the SACP.
- We are therefore affirming our 'A+' long-term issuer credit rating on Metropolitan.
- The negative outlook reflects that risks arising from Metropolitan's higher exposure to a noncore, more volatile, and less profitable sector, along with its expansion to areas with weaker economic fundamentals, could prompt us to lower our rating by a minimum of one notch in the coming year.

Rating Action

On July 21, 2017, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on U.K-based Metropolitan Housing Trust (Metropolitan). The outlook remains negative.

We also affirmed our 'A+' long-term issue rating on Metropolitan Funding PLC's £250 million senior secured bond. 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

We base our rating on Metropolitan on our assessment of its stand-alone credit profile (SACP), which we revised down to 'a' from 'a+' owing to pressure on both the financial and enterprise risk profiles. However, Metropolitan's creditworthiness benefits from a moderately high likelihood of extraordinary support from the U.K. government (unsolicited AA/Negative/A-1+), working through the Homes and Communities Agency, in the event of financial distress. We consequently include a one-notch uplift to our SACP for Metropolitan, leading us to affirm our 'A+' rating on the group.

In accordance with our criteria for government-related entities, including Metropolitan, we base our view of a moderately high likelihood of extraordinary government support on our assessment of Metropolitan's important role for the U.K. government and its public policy mandate, and its strong link with the U.K. government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

Metropolitan's enterprise risk profile is underpinned by low industry risk, along with strong economic fundamentals because most of the group's operations continue to be based in the London area (about 60% of its owned and managed properties as of the fiscal year-ended March 31, 2017). The London area benefits from stronger population growth than the national average and high market rents compared with Metropolitan's social and affordable housing properties, which in our view support robust demand for housing. In addition, we evaluate positively the gradual decrease in vacancies recorded by Metropolitan (slightly above 2.2% of net rental income, including service charge over 2015-2017), as well as an improvement in arrears that were less than 6% as of the end of fiscal 2017.

Nevertheless, given the group's intention to expand its activities outside of the London area and into regions marked by weaker economic fundamentals (namely the East Midlands and the East of England), we expect under our base case that its economic fundamentals will likely deteriorate. Metropolitan will also continue to generate a large portion of its revenues from non-traditional activities, standing at about 50% in 2020 under our base-case projection, up from 25% in 2017, due to a pronounced increase in private sales.

We consider that the group's development in private sales activity will continue to weigh on its financial risk profile. Market tenures will represent on average about 35% of the group's revenue base in 2018-2020 in our base case, as opposed to around 10% in 2016-2017. We consider market sales to be riskier than traditional social housing activities because of the higher volatility in demand and price levels inherent to open market operations. This coincides with the generally lower margins generated in this activity compared with the traditional social housing sector. We expect this trend will continue amid challenging conditions for the housing market over the near to medium term given Brexit-related uncertainty, which will also have a negative impact on Metropolitan's cost structure. In our base case, we incorporate hurdles for the housing market in 2018-2020, with prices remaining flat, at best, in the London area.

Due to the growing importance of development for private sales for Metropolitan, coupled with the continued toll of sector rent cuts until 2020, we anticipate that the group's earnings quality and profitability will come under pressure, resulting in weakening financial performance. We now forecast Metropolitan's adjusted EBITDA margin will average 27.5% over 2018-2020, compared with 32% in our October 2016 base-case forecast.

We continue to see Metropolitan's financial risk profile as strong as a result of the group's moderate debt and solid liquidity position. Despite our anticipation of a weaker adjusted EBITDA margin, we believe that Metropolitan's debt to adjusted EBITDA will not exceed 15x by 2020, with interest coverage at above 1.5x. In our view, the group's debt profile is also enhanced by a large amount of unencumbered assets representing more than 80% of its outstanding debt as of the end of fiscal 2017 (based on the latest Existing Use Value-Social Housing (EUV-SH) asset valuation). This provides additional flexibility to Metropolitan should it need to sell assets to reduce leverage or raise additional financing.

Liquidity

We now assess Metropolitan's liquidity position as strong, versus very strong previously, based on our estimate that sources of funding will gradually cover less than 1.75x of uses of funding over the next 24 months. In particular, we take into account the planned drawing on the £100 million retained tranche of the bond issuance in fiscal 2018, along with the group's higher investment effort we anticipate toward the end of our forecast period. We continue to factor in our view of Metropolitan's satisfactory access to external liquidity.

Outlook

The negative outlook reflects that we could lower our ratings on Metropolitan by a minimum of one notch over the next year if its current plan to increase its exposure to market sales and presence outside of London accentuated pressure on margins and liquidity more than what we project in our base case. In such a case, we would also consider revising down our assessment of the group's financial management.

The negative outlook on Metropolitan now also reflects the likelihood that we would lower the ratings if we were to downgrade the U.K. This would be because the one-notch uplift we currently factor into the rating from our SACP on Metropolitan for government support would no longer apply.

We could revise our outlook to stable over the next year if we believed that Metropolitan's strategy and the risks stemming from exposure to market tenures would not have a further material impact on its credit ratios, and if we saw evidence of strong flexibility to adjust to market changes, resulting in an adjusted EBITDA margin returning to the 30%-40% range.

Metropolitan Housing Trust Ltd. Selected Indicators

	2016a	2017bc	2018bc	2019bc	2020bc
Number of units	37,831	37,505	41,240	41,589	41,857
Vacancy rates (% of rent net of identifiable service charge + service and utility charge)	2.3	1.4	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge + service and utility charge)*	5.6	5.0	N.A.	N.A.	N.A.
Revenue§	234,106	260,834	316,692	377,270	414,403
Share of revenue from non-traditional activities (%)	18.0	25.7	38.3	46.2	50.4
Operating expense (before D&A)	138,312	151,129	201,825	255,973	298,612
EBITDA†	73,461	81,446	87,955	94,960	90,803
EBITDA/revenue (%)	31.4	31.2	27.8	25.2	21.9

Metropolitan Housing Trust Ltd. Selected Indicators (cont.)

	2016a	2017bc	2018bc	2019bc	2020bc
Interest expense	56,716	53,076	52,117	57,525	61,837
Debt/EBITDA (x)	14.9	12.8	13.9	14.1	15.4
EBITDA/interest coverage (x)**	1.3	1.5	1.7	1.7	1.5
Capital expense	112,440	162,396	204,000	276,000	237,000
Debt	1,095,446	1,046,232	1,220,384	1,336,083	1,402,316
Housing properties (according to balance sheet valuation)	2,740,665	2,851,221	N.A.	N.A.	N.A.
Loan to value of properties (%)	40.0	36.7	N.A.	N.A.	N.A.
Cash and liquid assets	182,283	104,190	49,481	20,669	623

*Rent and service charge arrears. §Adjusted for grant amortization. †Adjusted for capitalized repairs. **Including capitalized interest. a--Actual. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Related Criteria And Research

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 - December 17, 2014
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- U.K.-Based London & Quadrant Housing Trust 'A+' Rating Affirmed On Proposed Refinancing; Outlook Negative - July 5, 2017
- U.K. Social Housing Risk Indicators - June 9, 2017
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative - April 28, 2017
- High Demand For U.K. Social Housing Will Push Sector's Debt Above £80 Billion In FY2019 - March 20, 2017
- Outlook On U.K.-Based Metropolitan Housing Trust Revised to Negative On Heightened Sales Risk; 'A+' Rating Affirmed - October 31, 2016
- U.K.-Based Hyde Housing Association 'A+' Ratings Affirmed; Outlook Negative On Heightened Sales Risk, Oct. 31, 2016
- Credit FAQ: Brexit Uncertainties Mean Higher Credit Risk And Lower Ratings For The U.K. Social Housing Sector - October 31, 2016

Ratings List

	Rating	
	To	From
Metropolitan Housing Trust Ltd.		
Issuer Credit Rating		
Foreign and Local Currency	A+/Negative/--	A+/Negative/--
Senior Secured		
Local Currency	A+	A+
Metropolitan Funding PLC		
Senior Secured		
Local Currency	A+	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.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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.

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