S&P Global Ratings

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Research Update:

U.K. Social Housing Provider Paragon Asra Housing Ltd. Outlook Revised To Negative; 'A' Rating Affirmed

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Overview

- Paragon Asra Housing Ltd.'s (PA Housing's) focus on affordable tenures in areas of high demand for its units, and its very strong liquidity position, support our view of the group's creditworthiness.
- We expect that increasing investment in existing stock combined with the group's debt-funded ambitious development plan will put greater pressure on profitability and debt metrics than we had previously forecast.
- We therefore revised our outlook to negative from stable and affirmed our 'A' long-term issuer credit rating on PA Housing.
- The negative outlook indicates that over the next two years, higher-than-anticipated expenditure for PA Housing's existing asset base, combined with high debt intake for development capital expenditure (capex), could lead to a deterioration in financials.

Rating Action

On June 23, 2021, S&P Global Ratings revised to negative from stable its outlook on U.K.-based social housing provider PA Housing. At the same time, we affirmed our 'A' long-term issuer credit rating on PA Housing.

We also affirmed our 'A' issue ratings on the £250 million and £400 million senior secured bonds issued by PA Housing's funding vehicle, Paragon Treasury PLC.

Outlook

The negative outlook indicates that over the next two years, higher-than-anticipated expenditure for PA Housing's existing asset base, combined with higher debt intake for development capex, could weigh on the group's profitability and debt metrics to a greater extent than we currently estimate.

Downside scenario

We could lower the rating on PA Housing if further pressure on profitability leads to S&P Global Ratings-adjusted EBITDA margins standing structurally below 30%. Under this scenario, we could see higher-than-expected capitalized repairs or constrained sales margins weighing on the group's profitability. In addition, we could lower the rating if we thought that the likelihood of timely extraordinary support from the U.K. government had decreased.

Upside scenario

Alternatively, we could revise the outlook to stable if the group performs in line with our base case, with margins structurally recovering to stand above 30%. We could also revise the outlook to stable should our assessment of management improve, all else being equal.

Rationale

The outlook revision reflects the deterioration in the group's adjusted EBITDA margins, which, combined with its increasing debt burden, could weigh on its financials more than we currently forecast. The deterioration in profitability stems largely from the group's carbon neutral and building safety agenda, which will require additional investments in the short term in fire safety, and higher ongoing levels of operational expenditure. These are part of the group's wider environmental, social, and governance (ESG) framework, to meet energy-efficiency targets embedded in the group's business plan.

We anticipate that weaker profitability, when combined with the group's ambitious debt-funded development plan, will lead to a structurally high debt-to-nonsales EBITDA ratio. We now expect this ratio to remain above 20x across our three-year forecast period, as the group increases its nominal debt to above £1 billion from £800 million in fiscal year (FY) ending March 31, 2020. We expect interest coverage to remain solid, albeit on a similar weakening trend, due to our expectations that the group's profitability will be lower. This will be more acute in FY2022, because we expect fire-safety costs and a catch-up in repairs to constrain margins further. In our view, income from nonsales activities will continue to cover interest costs by 1.3x on average through 2024, supported by the recent £400 million bond issuance (of which £100 million remains retained), which has lowered the overall cost of debt for PA Housing.

We believe there is a moderately high likelihood that PA Housing would receive extraordinary government-related support in case of financial distress. This provides a one-notch uplift from the stand-alone credit profile (SACP) for PA Housing. A key goal of the Regulator of Social Housing (RSH) is to maintain lender confidence and low funding costs across the sector, so we believe it likely that the RSH would step in to try to prevent a default in the sector. We base this view on the RSH's track record of mediating mergers or arranging liquidity support from other registered providers in cases of financial distress and think this would also apply to PA Housing.

The 'A' rating is underpinned by strong market dependencies highlighting solid demand for the group's properties and a focus on low-risk traditional housing activities, while maintaining moderate exposure to development-for-sale activities. We also view the management team as having extensive experience in the social housing sector, with a strong focus on customer experience.

PA Housing benefits from strong demand for its properties in its areas of operations, with average social rents standing below 60% of market rents. The group owns and manages about 23,000 properties for social and affordable housing, with a geographical focus on three regions: London, Surrey, and the East Midlands. Operational metrics remain solid, with vacancy rates standing below 2% on average over the past three years. The pandemic led to an increase in void losses as well as modest increases in arrears, but we expect these to be temporary, and that vacancies will decline to historical levels.

The group's development ambitions remain in line with those of 2020 and are well aligned with management's capabilities, with only a minor reprofiling of units because of pandemic-related delays. The group expects to complete almost 400 units in FY2022, with over 500 in FY2023, reflecting the pandemic-induced delays and a step up in the program over the forecast period. The group still aims to complete 6,000 units over the next 10 years in its core area of operations, of which 60% will be for social and affordable rental tenures and 40% will be for shared ownership. We expect that most of the group's new development will be in London and Surrey.

We take into consideration that the group's exposure to development-for-sale activities will increase over the forecast period, averaging 20% of revenues over the forecast period. This is in line with the group's internal policy, which limits sales exposure to 25% of revenues. We view as a positive management's omission of outright market sales as a core tenure in its plan, and we expect management will deliver the plan in accordance with this rule.

We assess the regulatory framework under which registered providers of social housing in England operate as strong, underpinned by their public policy mandate to provide affordable homes. We also consider that the sector benefits from solid ongoing oversight by the RSH. These strengths are offset, in our view, by the relatively low levels of grant funding that the providers in England receive for the development of affordable homes. We consider that providers in England are able to develop homes for outright sale, using the proceeds as an alternative funding source. However, we think this exposes them to risks and potential volatility compared with providers in other regions. Providers in England are also subjected to negative intervention from the U.K. government in the form of constraints of rent setting or additional spending responsibilities, without adequate additional funding. This weighs on the regulatory framework assessment, in our view.

Liquidity

We assess PA Housing's liquidity position as very strong, supported by the recent issuance of its £400 million bond, of which £100 million is retained. We expect sources of liquidity to exceed planned uses by about 2.5x over the next 12 months. We continue to view PA Housing's access to external liquidity as satisfactory.

We expect liquidity sources will comprise:

- Forecast cash generated from continuing operation: £76 million;
- Cash and liquid investments, including proceeds from recent bond issuance: £341 million;
- Proceeds from asset sales: £5 million;
- The undrawn, available portion of committed bank facilities or bank lines maturing beyond the next 12 months, and which can be drawn: £304 million; and
- Expected ongoing cash injections from a government or group member as appropriate: £7.6 million.

We expect uses of liquidity will comprise:

- Expected capex: £171 million; and
- All interest and principal payable on short- and long-term debt obligations coming due: £118.6 million.

Key Statistics

Table 1

Paragon Asra Housing Ltd.--Key Statistics

	--Fiscal year ending March 31--				
Mil. £	2020a	2021e	2022bc	2023bc	2024bc
Number of units owned or managed	21,901.0	22,169.0	22,527.2	23,048.4	23,483.3
Adjusted operating revenue	144.2	151.5	173.6	197.5	206.2
Adjusted EBITDA	41.2	46.1	47.9	61.6	67.5
Non-sales adjusted EBITDA	37.6	42.2	39.4	48.6	54.9
Capital expense	112.7	90.0	171.0	166.5	139.5
Debt	800.9	881.6	1,001.6	1,071.6	1,104.9
Interest expense	30.5	31.6	33.0	34.7	36.1
Adjusted EBITDA/Adjusted operating revenue (%)	28.5	30.4	27.6	31.2	32.7
Debt/Non-sales adjusted EBITDA (x)	21.3	20.9	25.5	22.0	20.1
Non-sales adjusted EBITDA/interest coverage(x)	1.2	1.3	1.2	1.4	1.5

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

Paragon Asra Housing Ltd--Ratings Score Snapshot

	Assessment
Enterprise risk profile	3
Industry risk	2
Regulatory framework	3
Market dependencies	3
Management and governance	3
Financial risk profile	3
Financial performance	3
Debt profile	5
Liquidity	2

S&P Global Ratings bases its ratings on non-profit social housing providers on the seven main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published June 1, 2021, summarizes how the seven factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating.

Related Criteria

- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing Providers, June 1, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers Published, June 8, 2021
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 23, 2021
- Building Up Debt: U.K. Social Housing Sector Braces Itself For Borrowing, March 16, 2021
- Global Social Housing Ratings Score Snapshot: December 2020, Dec. 10, 2020
- Global Social Housing Ratings Risk Indicators: December 2020, Dec. 10, 2020
- Outlook 2021: Strong Liquidity Should Help Social Housing Providers Remain Resilient, Dec. 8, 2020
- ESG Industry Report Card: Public And Nonprofit Social Housing Providers Outside The U.S., Aug. 4, 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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Paragon Asra Housing Ltd.		
Issuer Credit Rating	A/Negative/--	A/Stable/--
Ratings Affirmed		
Paragon Treasury PLC		
Senior Secured	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