Research Update:

U.K.-Based Social Housing Association Futures Housing Group Outlook Revised To Stable; 'A+' Rating Affirmed

October 22, 2019

Overview

- U.K.-based Futures Housing Group (FHG) continues to subsidize housing development with nontraditional market sales activities, which enable it to deliver EBITDA margins above 30%, but expose the company to market risk.
- We see a lack of clarity in FHG's medium-term development plan, which makes the delivery of management's strategy unpredictable and also makes increases to the debt burden more volatile.
- Because operational efficiency, financial performance, and liquidity are forecast to remain strong, we are revising our outlook on FHG to stable from negative and affirming our 'A+' rating.
- The stable outlook reflects our expectation that FHG will maintain a very strong liquidity position to fund its development program and maintain its operational efficiencies to deliver strong financial performance.

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Rating Action

On Oct. 22, 2019, S&P Global Ratings revised to stable from negative its outlook on Futures Housing Group (FHG). We also affirmed our 'A+' long-term issuer credit rating on FHG.

At the same time, we affirmed our 'A+' issue rating on the £200 million bond issued in February 2019 by Futures Treasury PLC (FT), FHG's funding vehicle. FT was set up for the sole purpose of issuing bonds and lending the proceeds to FHG. We view FT as a core subsidiary of the Futures Housing Group.

Rationale

FHG is based in Derbyshire, which is part of the East Midlands, and owns and manages over 10,000 units. We believe the demand for social housing in its area of operations, mainly

Derbyshire, remains steady--local authority housing waiting lists in 2018 held over 10,500 households. However, East Midlands has weaker economic fundamentals than the south of England. Its house prices are lower than the national average and population growth is projected to be subdued.

In our view, the social housing sector has low industry risk because it benefits from low cyclicality and market volatility. We consider FHG as a traditional social housing provider as it generates over 80% of its revenues from traditional social rent activities. Exposure to real estate market volatility remains modest--sales activities are forecast to increase marginally to around 15% of total revenues in the financial year (FY) ending March 2020 and FY2021 before reducing to around 6% in FY2022.

Sales revenues from market activities has been higher than predicted in our previous base case, mainly driven by an increase in outright sales. However, we expect this activity to be contained and remain modest during our three-year forecast period. Although demand for low-cost home ownership units remains stable and FHG has achieved a share of first-tranche sales of around 50%, we consider that market sale activities carry higher external risk and expose the association to market and economic volatility.

Demand for FHG's social units remains high: vacancy rates comprise only about 1% of the rental income stream. Good operational efficiency is demonstrated by the low level of late rental payments--just 2.6% as at March 2019. Gross rental arrears increased marginally in 2019, mainly because of the full roll-out of Universal Credit, under which government support for rental costs may no longer be paid directly to the landlord. That said, we do not expect this to be a weakness for FHG. Our forecast suggests the arrears level will stabilize and then reduce over the next 12-24 months.

In our view, FHG's management is experienced and stable and has the right skills to deliver FHG's overall strategy. We also view the governance and risk management standards as good and suitable for the organization and its operating environment. Management maintains comprehensive financial policies, including prudent liquidity and debt management policies, which we view as positive. That said, the medium-term development program is vague and the overall program does not match the 60% market-led and 40% social units tenure mix that is detailed in FHG's development strategy. We anticipate that this could make management strategy more volatile and could weigh on the group's performance margins. In turn, this could increase the association's debt burden and expose it to market volatility and risk.

We view FHG's financial profile as strong. We forecast that around 500 new rental and 170 sales units will be developed over our three-year forecast period, contributing over £22 million to FHG's revenues and boosting the five-year average EBITDA margin to 37% and five-year average EBITDA interest cover to 2.4x, in line with our previous forecast. The average debt to EBITDA remains just over 10x.

Our base case assumes that the existing facilities will be sufficient to finance FHG's current development program over our forecast period. These facilities currently include about £113 million in traditional bank lines, including two undrawn revolving credit facilities (RCFs) totaling £38 million.

FHG also carried just under £32 million in cash and short-term investments as at March 2019. The surplus cash came from a refinancing exercise in FY2019, when FHG issued a £200 million public bond, of which it retained £50 million for future sale. We anticipate that FHG will use this surplus cash over the next 12 months for its development program.

We forecast that FHG's development program will require around £80 million in capital expenditure (capex) through FY2022. The program is currently 68% uncommitted, giving management flexibility to change or slow down capex if market and economic conditions change.

The relatively high loan-to-value ratio, which we estimate at above 70%, remains a constraining factor in our rating.

We think FHG benefits from a moderately high likelihood of extraordinary support from the U.K. government (AA/Negative/A-1+), working through the Regulator of Social Housing, in an event of financial distress. This has a neutral effect on the rating as the rating equals FHG's SACP.

We regard FHG as a government-related entity. We base our view of a moderately high likelihood of extraordinary government support on our assessment of FHG's important role for the U.K., as demonstrated through its public policy mandate and its strong link with the U.K. government. The government has a track record of providing strong credit support in certain circumstances.

Liquidity

We expect FHG's liquidity position to be very strong over the next 12 months, with sources of cash covering uses by 2.6x.

We forecast liquidity sources will amount to £90 million and comprise:

- Adjusted EBITDA used as cash flow proxy of £19 million;
- Cash and liquidity investments of £26 million;
- Proceeds from asset sales of £1 million;
- Undrawn committed facilities of £43 million; and
- Expected ongoing cash injections from the government and other miscellaneous receipts of £1 million.

We forecast uses of liquidity will amount to around £34 million and comprise:

- Expected capex of £25 million; and
- Interest and principal repayment of £9 million.

In our view, FHG's access to external liquidity remains satisfactory, given its ready access to bank funding and capital markets.

Outlook

The stable outlook on FHG reflects our expectation that FHG's management will maintain strong operational efficiency and financial performance, supported by high demand for social housing.

Downside scenario

The rating could come under pressure if there is a structural change in FHG's development strategy, so that sales revenues rise to more than 15% of total revenues in our base case. This is likely to result in a weaker financial performance than our base case forecast.

Upside scenario

We could raise the rating if a reduction in the lower-margin sales activity boosts FHG's EBITDA margins to over 40%, and improves its debt to EBITDA to below 10x and the average EBITDA interest cover to over 2.5x.

Key Statistics

Table 1

Association Futures Housing Group Selected Financial Indicators

	--Year ended March 31--				
(Mil. £)	**2018a**	**2019a**	**2020bc**	**2021bc**	**2022bc**
Number of units owned or managed	9,359	10,010	10,208	10,409	10,588
Vacancy rates (%)*	1.0	1.0	N.A.	N.A.	N.A.
Arrears (%)*	1.7	2.6	N.A.	N.A.	N.A.
Revenue§	49.7	50.0	55.8	56.6	55.3
Share of revenue from nontraditional activities (%)	13.0	11.7	19.1	17.1	10.7
EBITDA§†	18.7	19.9	18.8	20.2	21.7
EBITDA/revenue §†(%)	37.5	39.8	33.7	35.7	39.3
Interest expense**	6.6	8.7	8.7	8.6	8.6
Debt/EBITDA §†(x)	7.7	10.9	11.5	10.7	9.9
EBITDA/interest coverage§†** (x)	2.8	2.3	2.2	2.3	2.5
Capital expense†	18.3	79.4	29.0	23.2	26.4
Debt	144.5	217.0	217.0	215.3	215.3
Housing properties (according to balance sheet valuation)	164.8	228.6	N.A.	N.A.	N.A.
Loan to value of properties (%)	87.7	94.9	N.A.	N.A.	N.A.
Cash and liquid assets	16.0	31.8	22.1	17.0	7.9

*Rent and service charge. §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

Futures Housing Group Ratings Score Snapshot

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

Table 2

Futures Housing Group 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

- United Kingdom Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, April 26, 2019

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Futures Housing Group		
Issuer Credit Rating	A+/Stable/--	A+/Negative/--
Futures Treasury PLC		
Senior Secured	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.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.