S&P Global Ratings

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Research Update:

U.K.-Based Social Housing Provider Stonewater Ltd. 'A' Rating Affirmed; Outlook Negative

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Overview

- We consider that English social housing provider Stonewater Ltd.'s increasing investments in its existing assets and high inflation are putting pressure on its financial performance and delaying the improvement we previously anticipated.
- We forecast that the group's debt burden will be steadily increasing to expand its rental portfolio, but we think this will also strengthen its revenue base to support the recovery of the credit metrics.
- We therefore affirmed our 'A' long-term issuer credit rating on Stonewater and kept the outlook negative.

Rating Action

On Nov. 2, 2023, S&P Global Ratings affirmed its long-term issuer credit rating on U.K.-based social housing provider Stonewater Ltd. at 'A'. The outlook is negative.

We also affirmed our 'A' issue ratings on the three senior secured bonds issued by Stonewater Funding PLC, and on Stonewater Funding's £1 billion senior secured and unsecured medium-term notes program. We consider that Stonewater Funding was set up for the sole purpose of issuing bonds and lending the proceeds to the group, and we view it as a core subsidiary of Stonewater.

Outlook

The negative outlook reflects our view that elevated investments in new and existing assets, combined with persistently high inflation, could weaken Stonewater's financial performance and elevate its debt burden more than we currently expect.

Downside scenario

We could lower the ratings if, over the next 12 months, Stonewater loosens control over the cost base, or if it further expands its development ambitions. Under this scenario, we expect debt to S&P Global Ratings-adjusted nonsales EBITDA exceeding 20x or adjusted nonsales EBITDA interest cover going below 1.25x on a sustained basis.

Upside scenario

We could revise the outlook to stable if Stonewater succeeds in containing both the pressure on its financial performance and new borrowings, such that the adjusted EBITDA margin and debt metrics improve in line with or faster than our forecasts.

Rationale

The affirmation reflects our view that Stonewater's debt profile is on an improving trend through the forecast period. We think that the management carefully carries out its development program with a view to maintaining the group's financial resilience. Although we forecast that the group will take on more debt than in our previous projection, part of it will come from the expected merger with Mount Green Housing Assn., assumed in our current base case, which will bring the rental revenue of its existing units to the group. We also expect that it will scale back its own new developments and pursue grants through its Homes England strategic partnership in conjunction with the Guinness Partnership to slow its debt buildup. As a result, we project that debt metrics will have a gradual recovery, albeit slower than our previous expectations. Meanwhile, we think that the financial performance will remain satisfactory with five-year average adjusted EBITDA margins close to 30%, which is better than peers'. We assume that rent increases will outpace the growing cost base in the coming two to three years, which will somewhat offset the pressure from investment in existing homes and inflation.

Enterprise profile: Stonewater's focus on traditional social housing rentals supports its credit quality.

Stonewater continues to generate most of its earnings in the predictable and countercyclical social housing sector. The group's sales exposure is largely shared ownership sales. We expect that the group will contain its exposure to sales income, at about a moderate 15% of the group's total adjusted revenue on average in the coming two to three years.

In our view, the demand for Stonewater's properties remains strong. The group's social and affordable rent is at a fairly low level of about 66% of the market rent, which supports the demand for its properties. The strong demand is also evident in the group's vacancy rate, which has averaged just 0.9% of the rent and service charge receivable over the past three years and which we consider to be on par with the sector in England.

We think that Stonewater's management is mindful of the sector's challenges and is taking proactive actions to protect its financial profile. We noted that it is smoothing out its development plan and is actively pursuing more grants to subsidize its investment in new and existing homes, although the recovery of the group's financial metrics will be gradual in our view. We understand that Stonewater is also growing its asset base through mergers and stock acquisitions, but we think that the management will consider these options cautiously to ensure they will not undermine its financial resilience.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (see "Regulatory Framework Assessment: Social Housing Providers In

The U.K. Benefit From Strong Regulatory Frameworks," published October 23, 2023, on RatingsDirect).

Financial profile: Stonewater's financial metrics still face pressure from investment in existing homes and high inflation.

We forecast that the group could still maintain decent financial performance, although it remains under pressure from its increasing investment in existing assets and the inflationary cost environment, which will keep our projected adjusted EBITDA margins under 30% in the coming two to three years. We note that Stonewater's investment in existing assets has started to rise in the last two years, with some of the fire safety spend covered by the legal settlement with the contractors received in fiscal 2021 (ended March 31, 2021). We expect that the investment level will be higher than in the last two years, with a view to improving the quality and energy efficiency of its housing stock, although we assume that the group will recover some of these investments, including the Social Housing Decarbonization Fund, partly offsetting the related costs. We noted that inflation eroded both adjusted EBITDA and EBITDA margins in fiscal 2023, when inflation exceeded rent increases. The government's 7% rent cap in fiscal 2024 hinders the group from compensating for costs. Nevertheless, we expect that the group can increase its rental fees, which will slightly outpace cost inflation in the coming two to three years.

We project that Stonewater's debt profile will remain weak in the near term compared with the historical level because of the pressures on adjusted EBITDA and additional debt to support asset growth, and will take longer time to recover than our previous expectation. We understand that Stonewater is reducing its development of new homes and that it has flexibility beyond fiscal 2025. It has also secured grant funding from Homes England through its strategic partnership status to subsidize some of the development spend. Still, the group will take on new debt moderately and will therefore increase interest expense, further heightened by the currently rising interest rate environment, which we only expect to ease off in the approach to fiscal 2026. Moreover, we consider that the expected merger with Mount Green in the last quarter of fiscal 2024 will temporarily weaken the debt metrics because only a quarter of the rental revenue but the whole debt from Mount Green will be consolidated into Stonewater. The metrics will improve in the next year, however, when Mount Green's full-year financials are considered.

We view Stonewater's liquidity as very strong. The group's liquidity sources cover uses by approximately 2.2x in the next 12 months. This is based on our forecast of liquidity sources of about £699 million--comprising cash, undrawn and available revolving credit facilities, asset sales, grant receipts, and cash from operations (adding back the noncash cost of sales) that will cover liquidity uses of about £318 million (mainly capital expenditure and debt service payments). At the same time, we believe Stonewater retains satisfactory access to external liquidity when needed.

Government-related entity analysis

We believe there is a moderately high likelihood that Stonewater would receive timely extraordinary support from the U.K. government, through the Regulator of Social Housing (RSH) in case of financial distress. This provides a one-notch uplift from the stand-alone credit profile. As one of the key goals of the RSH is to maintain lender confidence and low funding costs across the sector, we believe it is likely that the RSH would step in to try and prevent a default in the sector. We base this view on previous records of the RSH mediating mergers or arranging liquidity support from other registered providers in cases of financial distress and think this would also apply to

Stonewater.

Selected Indicators

Table 1

Stonewater Ltd.--Financial statistics

	--Year ended Mar. 31--				
Mil. £	**2022a**	**2023a**	**2024bc**	**2025bc**	**2026bc**
Number of units owned or managed	35,433	36,981	39,788	40,596	41,527
Adjusted operating revenue	218.3	231.7	254.5	286.3	317.5
Adjusted EBITDA	63.5	55.9	65.2	81.1	92.8
Nonsales adjusted EBITDA	56.3	50.5	60.6	76.8	89.6
Capital expense	202.0	194.5	271.5	211.5	184.4
Debt	1,247.0	1,384.1	1,535.9	1,556.6	1,611.9
Interest expense	42.3	46.6	59.9	61.3	58.2
Adjusted EBITDA/Adjusted operating revenue (%)	29.1	24.1	25.6	28.3	29.2
Debt/Nonsales adjusted EBITDA (x)	22.2	27.4	25.4	20.3	18.0
Nonsales adjusted EBITDA/interest coverage(x)	1.3	1.1	1.0	1.3	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

Stonewater 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	4
Debt profile	4
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 on 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

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- Regulatory Framework Assessment: Social Housing Providers In The U.K. Benefit From Strong Regulatory Frameworks, October 23, 2023
- U.K. Social Housing Providers' Credit Headroom Could Tighten If The Operating Environment Deteriorates, October 4, 2023
- United Kingdom Outlook Revised To Stable From Negative On Moderating Fiscal Risks; 'AA/A-1+' Ratings Affirmed, April 21, 2023
- U.K. Social Housing Borrowing 2023: On Pause, March 28, 2023
- Non-U.S. Social Housing Providers Ratings Score Snapshot: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings Risk Indicators: March 2023, March 27, 2023
- Non-U.S. Social Housing Providers Ratings History: March 2023, March 27, 2023
- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022
- Non-U.S. Social Housing Sector Outlook 2023: The Most Negative Bias Since 2018 Implies Significant Pressure On Ratings, Dec. 1, 2022
- Inflation To Erode The Performance Of U.K. Public Finance Sectors, Nov. 29, 2022
- Cap On Rent Increases Is Consistent With Our Base Case For English Social Housing Providers, Nov. 17, 2022
- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 2022
- Launch Of Rent Cap Consultation Adds Uncertainty To Creditworthiness Across English Housing Sector, Sept. 1, 2022
- Rated U.K. Social Housing Providers' Creditworthiness Could Suffer If The Gap Between Rent And Cost Increases Persists, Aug. 1, 2022

Ratings List

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