Research Update:

U.K.-Based Housing Association Incommunities Group Ltd. Rating Affirmed At 'A+'; Outlook Negative

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Overview

- We expect Incommunities Group Ltd.'s (Incommunities) debt build-up to remain contained over our forecast horizon, supported by additional secured grant funding and the reprofiling of the group's development plan.
- We forecast that increasing investments in existing properties, along with rising inflation costs, will put pressure on the group's S&P Global Ratings-adjusted EBITDA.
- We affirmed our 'A+' long-term issuer credit rating on Incommunities. The outlook remains negative.

Rating Action

On March 28, 2022, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on Incommunities. The outlook is negative.

At the same time, we affirmed our 'A+' rating on the £250 million senior secured bond issued by Incommunities Treasury PLC in March 2019. Incommunities Treasury PLC was set up for the sole purpose of issuing bonds and lending the proceeds to the group, and as such we view it as a core subsidiary of Incommunities.

Outlook

The negative outlook indicates that the group's financial metrics could structurally weaken beyond our current forecast on the back of increasing cost pressures.

Downside scenario

We could lower the rating on Incommunities over the next 12 months if the group's performance slips below our current projections, resulting in adjusted EBITDA margins remaining structurally below 20%. This could materialize if costs are significantly higher than we currently project due to inflationary pressures and required investments in existing homes, or if we see a shift in the strategy to incorporate meaningfully higher levels of market sale activities. This could also put pressure on the group's debt metrics. We could also lower the rating if we assessed the likelihood of support from the government to have weakened.

Upside scenario

We could revise the outlook back to stable if management is able to successfully deliver its development plan along with containing the cost pressures. We think this could result in a material recovery in the group's EBITDA margins and support the strengthening of its debt metrics.

Rationale

The rating reflects our view that the group's strong focus on stable low-income housing rental activities and contained debt build-up will support solid interest coverage. However, rising inflation, combined with increased spend on existing assets, could weigh on the group's financial performance beyond what we currently anticipate. We expect the group's repairs program to more than double in the latter years of our base-case period, largely attributed to enhanced building and fire safety standards and the U.K. government's agenda to improve energy efficiency. We expect this to strain the group's adjusted EBITDA margins.

Incommunities owns and manages more than 22,500 homes across South and West Yorkshire. We estimate the group's average social and affordable rent to be about 64% of the average market rent across its area of operations, which supports continued strong demand for Incommunities properties. This is also demonstrated by average vacancy rates of 1.5%, which we estimate to be on a par with the sector average.

We believe there is a moderately high likelihood that Incommunities would receive timely extraordinary government related support 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 Regulator of Social Housing (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 Incommunities.

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. Offsetting these strengths, we consider that providers in England receive relatively low levels of grant funding for the development of affordable homes. We note that providers in England can 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 rent-setting constraints or additional spending responsibilities, without adequate additional funding. This weighs on our view of the regulatory framework assessment.

We think Incommunities' management has adequate expertise in the housing sector and a set of comprehensive financial policies attuned to the risks associated with the nature of its core business.

We continue to view the group's strategy as relatively risk averse, with more than 90% of its turnover stemming from rental revenue on average over our forecast horizon. The group has reprofiled its development plan and substituted some of its outright sale activities with more shared ownership first-tranche sales, keeping the exposure to riskier market sale activities at contained levels. This change in the tenure mix is in line with the Homes England Strategic Partnership requirement, since the group has secured higher levels of grant funding than previously anticipated. We expect the group to deliver close to 450 homes over our forecast horizon--the financial year ending March 31, 2022 (FY2022)-FY2024--which represents a modest 2% increase to the existing asset base. This is lower than we previously anticipated, but we understand there would be a pick-up in unit deliveries beyond our forecast horizon.

We expect that the planned increase in existing asset investments will weigh on the group's profitability. A catch-up on the repairs works following lockdown-induced delays, combined with the estimated high inflation costs, will stress the group's adjusted EBITDA margins for FY2023. For FY2024, we project the favorable rent environment and expanding asset base will support a gradual recovery in the group's adjusted EBITDA ratio, albeit with margins remaining close to 20%. The group would continue to benefit from the natural safeguard in the sector that allows for an annual consumer price index +1% rent increase under the last rent settlement, applicable for five years from April 1, 2020.

We project that the reduced funding needs would somewhat counterbalance the impact of weaker EBITDA on the debt metrics. We forecast Incommunities non-sales adjusted EBITDA to debt to average above 15x over FY2022-FY2024 and interest coverage to average at about 2x over the same period. Although we expect the group's debt metrics to be weaker than historical levels, it will likely remain more resilient compared with many of the group's peers.

Liquidity

We assess liquidity as very strong. We estimate sources of liquidity will cover uses by about 4.4x over the next 12 months due to lower capital spend in the initial years of the plan and the already secured credit lines. We expect this ratio to weaken thereafter, in line with the growth in capital expenditure (capex). We continue to view Incommunities' access to external liquidity as satisfactory.

We expect sources of liquidity over the next 12 months will include:

- Cash flow from operations, adding back noncash cost of sales of about £20 million;
- Current cash and liquid investments of £22 million;
- Fixed-asset sales receipts of about £4 million;
- Committed and undrawn facilities expiring beyond 12 months of about £105 million; and
- Grant receipt of just under £2 million.

We expect uses of liquidity over the same period will include:

- Capex including development spending on homes for sale of just under 24 million; and
- Interest and principal repayments of about £11 million.

Key Statistics

Table 1

Incommunities Group Ltd. -- Key Statistics

	--Year ended March 31 --				
Mil. £	**2020a**	**2021a**	**2022bc**	**2023bc**	**2024bc**
Number of units owned or managed	22,991	22,651	22,692	22,708	22,852
Adjusted operating revenue	100.5	99.1	100.0	105.6	119.6
Adjusted EBITDA	23.6	25.6	23.8	16.9	23.2
Non-sales adjusted EBITDA	22.6	25.2	23.2	15.8	20.4
Capital expense	7.7	12.8	17.1	24.0	48.5
Debt	301.8	292.7	292.1	290.8	297.9
Interest expense	10.6	10.2	10.0	10.0	10.1
Adjusted EBITDA/Adjusted operating revenue (%)	23.4	25.8	23.8	16.0	19.4
Debt/Non-sales adjusted EBITDA (x)	13.4	11.6	12.6	18.4	14.6
Non-sales adjusted EBITDA/interest coverage(x)	2.1	2.5	2.3	1.6	2.0

a--Actual. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Incommunities Group 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	3
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

- Social Housing Outlook 2022: Green Agenda Takes Root In Investment Plans, Nov. 23, 2021
- How U.K. Public Finance Sectors Fare Under Latest Spending Review, Nov. 11, 2021
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 22, 2021
- Global Regulatory Framework Report Card For Public And Nonprofit Social Housing Providers Published, June 8, 2021
- Building Up Debt: U.K. Social Housing Sector Braces Itself For Borrowing, March 16, 2021
- 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

Ratings List

Ratings Affirmed	
Incommunities Group Ltd.	
Issuer Credit Rating	A+/Negative/--
Incommunities Treasury PLC	
Senior Secured	A+

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