Research Update:

ClwydAlyn Housing Ltd. 'A' Rating Affirmed; Outlook Stable

July 14, 2020

Overview

- Wales-based social housing provider ClwydAlyn Housing Ltd. (ClwydAlyn) benefits from operating in a low-risk industry and a favorable regulatory environment, which involves generous grant funding from the Welsh government.
- Our rating on ClwydAlyn is constrained by its high levels of leverage compared with other rated peers, and weak economic fundamentals in its areas of operations.
- We have affirmed our 'A' long-term issuer credit rating on ClwydAlyn.
- The stable outlook is based on our view that ClwydAlyn's predictable revenue base will support the entity through COVID-19-related headwinds.

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Rating Action

On July 14, 2020, S&P Global Ratings affirmed its 'A' long-term issuer credit rating on ClwydAlyn Housing Ltd. (ClwydAlyn). The outlook is stable.

At the same time, we affirmed our 'A' issue rating on the £250 million bond issued by PenArian Housing Finance PLC, a core subsidiary of ClwydAlyn.

Rationale

The affirmation reflects the group's focus on traditional social housing activities, and the supportive policy framework from which it benefits, with a generous grant environment and more flexible rental regime compared with some English regions.

The 'A' rating includes a two-notch uplift from ClwydAlyn's stand-alone credit profile (SACP) of 'bbb+', based on our opinion of the Welsh government's capacity to support public sector enterprises, and our view that it is highly likely to provide timely and sufficient extraordinary support to ClwydAlyn in the event of financial distress. This assessment is based on our view that ClwydAlyn plays an important role for the Welsh government in social housing provision.

We also consider that ClwydAlyn has a very strong link to the Welsh government because the government directly regulates the social housing sector, thus providing strong regulatory oversight. The Welsh government periodically attends board-level meetings and it disburses grant funding directly, ensuring that funding is consistent.

ClwydAlyn faces less favorable economic fundamentals than most U.K. peers, with one of the lowest population growths among U.K. regions. Because market rents are lower in Wales than in other U.K. regions, ClwydAlyn is at risk of competing with private landlords, as its rents are only marginally lower than market rents. Wales' rent environment, although more favorable than England's, also contributes to reducing the gap between social and market rents. In fiscal year (FY) ending March 31, 2020, the Welsh government announced a five-year rent settlement that will allow social housing providers to increase rents by consumer price index (CPI) inflation +1% over the period. This will continue to raise social rents and narrow the gap between social and market rents.

ClwydAlyn's excellent asset quality and operational performance offsets the weaker economic conditions in its region. Over the past three years, vacancies have remained below 2% of rent and service charges. Gross arrears are lower than most peers operating in areas of similar economic conditions, averaging 4% over the past three years, which demonstrates effective operational stock management. That said, the rollout of the Universal Credit welfare system across Wales has exacerbated the rise in arrears. To counter this, ClwydAlyn has been placing vulnerable tenants on Alternative Payment Plans (APA). In FY2020, it had 179 tenants on APAs, up from 105 in FY2018.

Although we expect that the COVID-19 pandemic will hamper rent collection, the group's low dependence on self-paying tenants protects its income levels. We forecast only a small, temporary reduction in rent collected in FY2021 due to COVID-19, which will slightly hamper profitability during the year. Less than one-third of total income comes directly from residents, with 69% coming from different government sources and subsidies (local authorities, housing benefit, Universal Credit, and housing grants).

Our expectation is that ClwydAlyn will continue to focus on the delivery of its development plan, through which it aims to deliver 1,500 units by 2023, mainly for social rent and supported housing. The group has completed almost 500 units so far, and we expect it will deliver a further 1,000 units over the next three years. Our base case assumes some slippage in the delivery of the development program, as completions are delayed by COVID-19-related site closures. We expect development will be funded through a combination of substantial capital grants from the Welsh government, internal cash-flow generation and an increase in borrowings. Around 50% of the cost of the planned completions is likely to be subsidized by government grants. We view ClwydAlyn's management as having significant experience in the social housing sector, with a development strategy that is aligned to its capabilities.

The group's ambition to expand its asset base, combined with a favorable rent regime, will support strengthening EBITDA margins from FY2022 onward. Over our five-year base case, we expect S&P Global Ratings-adjusted EBITDA margins to average 25%, trending toward 27% by FY2023. Development for social homes will expand ClwydAlyn's predictable revenue-generating asset base. Since 2018, ClwydAlyn has completed almost 500 homes, reducing average cost per unit while increasing weekly rents. ClwydAlyn continues to benefit from a more favorable policy environment than its English peers, largely due to the grant environment and more flexible rental regime. Housing is a devolved function for Wales, granting the Welsh government autonomy over setting rent levels and housing targets. Social landlords in Wales can increase their social rents in line with CPI +1%; however, we incorporate in our base case the expectation that inflation growth across the U.K. has slowed down in 2020 (see "The U.K. Faces A Steep Climb To Recovery," published July 1, 2020), which will translate into a lower rent increase allowed in 2021.

Although grants will support almost half of the group's development plan, it will also require

ClwydAlyn to incur additional debt. We expect debt to increase from £205 million in FY2020 to £247 million in FY2023. Historically, ClwydAlyn has operated a revenue grant system, which required the group to raise debt in anticipation of receiving revenue grants, raising the group's leverage higher than most rated peers. We expect it will now service a proportion of this debt through grants received from the Welsh government. Due to COVID-19-related pressures on profitability in FY2021, we expect debt-to-EBITDA to surpass 20x during the current year, decreasing toward 18x as profitability improves in FY2022-FY2023. Despite the projected increase in debt, we forecast adjusted EBITDA interest coverage to remain stable at 1.5x over the forecast period.

Liquidity

We view ClwydAlyn's liquidity position as strong, in line with our last base case. We project sources of liquidity to cover uses by 1.55x, supported largely by undrawn facilities and government grants.

We forecast that liquidity sources will comprise:

- Our forecast of cash generated from continuing operations of £11.4 million;
- Cash and liquid investments of £13.9 million;
- The undrawn, available portion of committed bank facilities or bank lines maturing beyond the next 12 months of £52.4 million; and
- Our expectation of ongoing cash injections from the government of £25.7 million.

We forecast that uses of liquidity will comprise:

- Our expectation of capital expenditure (capex) of £55.2 million; and
- Interest and principal payments of £11.5 million.

We continue to view ClwydAlyn's access to external liquidity as satisfactory.

Outlook

The stable outlook is based on our view that ClwydAlyn's predictable revenue base will support the entity through COVID-19-related headwinds, and that the group will perform in line with our base-case scenario.

We could lower the rating on ClwydAlyn should its financial performance deteriorate as a result of further expansion into the low-margin care business, or significant increases in its cost base. We could also lower the rating if ClwydAlyn's liquidity position deteriorates further.

We could also downgrade ClwydAlyn if we were to change our view on the likelihood of the Welsh government providing extraordinary support in case of need.

We could raise our rating on ClwydAlyn if it structurally improved its liquidity position such that sources comfortably exceed uses by 1.75x, and if the debt burden declines faster than we anticipate.

Key Statistics

Table 1

ClwydAlyn Housing Ltd. Key Statistics

	--Year ended March 31--				
(Mil. £)	2019a	2020e	2021bc	2022bc	2023bc
Number of units owned or managed	5,998	6,054	6,272	6,655	7,067
Revenue§	41.7	43.9	43.7	47.8	52.0
Share of revenue from sales activities (%)	0.0	0.0	0.0	0.0	0.0
EBITDA§†	9.6	11.3	10.7	12.7	13.8
EBITDA/revenue §†(%)	22.9	25.6	24.4	26.5	26.6
Capital expense†	23.0	51.3	62.9	40.0	40.3
Debt	205.7	205.7	232.3	243.3	246.7
Debt/EBITDA §†(x)	21.5	18.3	21.7	19.2	17.8
Interest expense*	7.4	7.4	7.9	8.6	8.9
EBITDA/interest coverage§†* (x)	1.3	1.5	1.4	1.5	1.6
Cash and liquid assets	32.0	15.1	12.5	14.6	16.6

*Including capitalized interest. §Adjusted for grant amortization. †Adjusted for capitalized repairs. a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

ClwydAlyn Housing Ltd. Ratings Score Snapshot

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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 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 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 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
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Global Social Housing Ratings Score Snapshot: December 2019, Dec. 2, 2019
- Global Social Housing Risk Indicators: December 2019, Dec. 2, 2019

Ratings List

Ratings Affirmed	
ClwydAlyn Housing Ltd	
Issuer Credit Rating	A/Stable/--
PenArian Housing Finance PLC	
Senior Secured	A