Research Update:

U.K. -Based Housing Association Incommunities Group Ltd. Downgraded To 'A' On Weaker Margins; Outlook Negative

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Overview

- We expect Incommunities Group Ltd. to invest more in existing assets than we previously anticipated.
- At the same time, inflation is driving up Incommunities' cost base, which will reduce the group's S&P Global Ratings-adjusted EBITDA margin to below 20%.
- In our view, these factors, together with the increasing debt the group will take on to fund its development program, will likely weaken Incommunities' debt metrics.
- We therefore lowered our long-term issuer credit rating on Incommunities to 'A' from 'A+'. The outlook is negative.

Rating Action

On March 28, 2023, S&P Global Ratings lowered to 'A' from 'A+' its long-term issuer credit rating on U.K.-based social housing provider Incommunities Group Ltd. The outlook is negative.

At the same time, we lowered to 'A' from 'A+' our issue rating on the £250 million senior secured bond issued by Incommunities Treasury PLC in March 2019. Incommunities Treasury PLC was set up solely to issue bonds and lend the proceeds to the group. We therefore view it as a core subsidiary of Incommunities.

Outlook

The negative outlook reflects the increasing risk that the group's financial indicators will structurally weaken beyond our current forecasts.

Downside scenario

We could lower the rating on Incommunities over the next 24 months if management is unable to support the anticipated recovery in its performance , and strengthen its debt metrics. This could materialize if the group's EBITDA deteriorated significantly, for example, due to higher costs than we currently project driven by inflationary pressures and investment required in existing homes, or if the debt-funded development program materially exceeded our current forecasts.

Upside scenario

We could revise the outlook to stable if the group manages to contain cost pressures while balancing the investment needs in existing and new homes. We think this would be reflected in performance and debt metrics improving faster than our forecasts.

Rationale

The downgrade reflects our forecast that Incommunities' financial metrics are set to weaken materially compared with our previous forecasts. This is due to the increasing investment in existing assets, to address enhanced building and safety standards and the push toward energy efficiency, further exacerbated by inflationary pressures. Considering this, alongside the government-imposed rent caps, we expect the group's EBITDA to remain squeezed. Furthermore, we think that the increase in borrowing to fund its capital program, given the weaker financial performance and rising interest-rates, will strain the group's debt metrics.

Incommunities owns and manages close to 23,000 homes across South and West Yorkshire. We think that the group's social and affordable rents, which we estimate to be just over 65% of the market average rent across the area of operations, reflects solid affordability levels that support the high demand for its properties. This high demand is also demonstrated by vacancy rates of about 1.5% on average over the past three years, which we estimate to be on par with the sector average. We anticipate the group's vacancy rates will improve following the longer relet times during the pandemic, reflecting satisfactory management of its stock.

We believe Incommunities' management is experienced and has adequate expertise in the housing sector. 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 (financial year 2023 [ending March 31, 2023]-financial year 2025). Following the changes in the group's executive team over the past two years, we understand that its strategy with respect to investments in existing stock has been updated to address the heightened regulatory requirements around stock quality. We estimate this to have resulted in materially more spending toward energy efficiency and maintenance works than we previously anticipated. Currently, the group's stock is below the sector average in terms of meeting Energy Performance Certificate (EPC) C standards. Though we acknowledge management's efforts to strengthen its strategy and improve the quality of its existing stock, this step up in investment needs is likely to stretch the group's financial capacity.

We forecast Incommunities' adjusted EBITDA margins will structurally weaken and remain below 20% through to the end of our base-case period. We expect that a rent increase significantly below inflation in financial year 2023, a 7% cap on the rent increase in financial year 2024 coupled with an elevated cost base will squeeze the group's margins and contain the projected recovery in EBITDA. The forecasted pressure on the cost base stems from the increasing investment in existing stock, further exacerbated by inflation. In our view, spending on existing stock would continue to increase as costs to address fire and building safety standards would gradually be replaced by investments to reach a minimum EPC rating of C by 2030 and achieving a net zero carbon by 2050.

Though the group's development aspirations remain similar to our previous base-case assumptions, we expect the pressure on EBITDA and rising interest rates to weigh on the group's debt metrics. We forecast Incommunities' debt to S&P Global Ratings-adjusted non-sales EBITDA ratio to average to about 20x and interest coverage to average about 1.4x over our forecast horizon. We think that though the group's interest coverage is significantly weaker than our previous estimates, it will likely remain more favorable than many of the group's peers', owing to its low cost of existing debt.

We assess the regulatory framework under which registered providers of social housing in England operate as strong (for more information see "Global Regulatory Framework Report Card: Public And Nonprofit Social Housing Providers," published June 8, 2021).

We believe there is a moderately high likelihood that Incommunities would receive timely extraordinary government related support in case of financial distress. This leads us to apply a one-notch uplift to the stand-alone credit profile (SACP) to derive the issuer credit rating. 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.

Liquidity

We assess Incommunities' liquidity as very strong. We estimate that sources of liquidity will cover uses by about 2.7x over the next 12 months. However, we expect this ratio to slightly weaken thereafter owing to the expected depletion in cash levels and increasing 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 close to £20 million;
- Current cash and liquid investments of just under £15 million;
- Fixed-asset sales receipts of about £6 million;
- Committed and undrawn facilities expiring beyond 12 months of about £105 million; and
- Grant receipt of about £21 million.

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

- Capex including development spending on homes for sale of just under 50 million; and
- Interest and principal repayments of about £12 million.

Key Statistics

Table 1

Incommunities Group Ltd.--Key Statistics

	--Year ends March 31--				
Mil. £	2021a	2022a	2023e	2024bc	2025bc
Number of units owned or managed	22,651	22,708	22,701	22,779	23,030
Adjusted operating revenue	99.1	101.3	104.4	114.6	122.0
Adjusted EBITDA	25.6	17.6	13.2	16.4	18.3
Non-sales adjusted EBITDA	25.2	16.5	12.5	14.9	16.6
Capital expense	12.8	19.3	27.3	51.1	41.9
Debt	292.7	282.6	283.9	300.5	318.9
Interest expense	10.2	10.1	10.1	10.5	11.3
Adjusted EBITDA/Adjusted operating revenue (%)	25.8	17.4	12.6	14.3	15.0
Debt/Non-sales adjusted EBITDA (x)	11.6	17.1	22.8	20.2	19.2
Non-sales adjusted EBITDA/interest coverage(x)	2.5	1.6	1.2	1.4	1.5

a--Actual. e--Estimate. 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	4
Financial performance	5
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.

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Climate transition risks

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

- U.K. Social Housing Borrowing 2023: On Pause, March 28, 2023
- Non-U.S. Social Housing Providers Ratings History: March 2023, March 27, 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
- 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
- United Kingdom, Oct. 24, 2022
- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 2022
- Economic Outlook U.K. Q4 2022: Under The Pump, Oct. 3, 2022
- United Kingdom Outlook Revised To Negative On Rising Fiscal Risks; 'AA/A-1+' Ratings Affirmed, Sept. 30, 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
- Global Regulatory Framework Report Card: Public And Nonprofit Social Housing Providers, June 8, 2021

Ratings List

Downgraded

	To	From
Incommunities Group Ltd.		
Issuer Credit Rating	A/Negative/--	A+/Negative/--
Incommunities 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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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; or Stockholm (46) 8-440-5914