MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
11 March 2022

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RATINGS

Midland Heart

Domicile	United Kingdom
Long Term Rating	A1
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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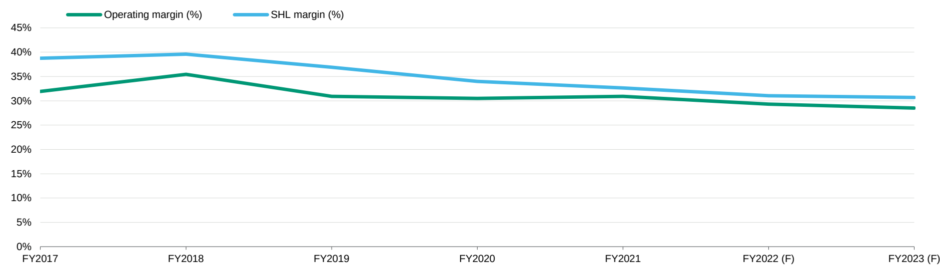
Midland Heart (UK)

Update to credit analysis

Summary

The credit profile of Midland Heart (A1 stable) reflects its stable strategy and financial metrics, relatively low debt, healthy operating performance and interest coverage ratios, as well as a material standalone swap portfolio. It also incorporates a strong likelihood that the government of the United Kingdom (UK, Aa3 stable) would intervene in the event of the housing association (HA) facing acute liquidity stress.

Exhibit 1
Midland Heart's strong operating performance is underpinned by its core social housing profitability
Operating margin (%), social housing lettings margin (%), FY2017 - FY2023 (F)



Source: Midland Heart, Moody's Investors Service

Credit strengths

» Strong financial management, with a focus on low-risk social housing activities

» Healthy financial performance, with strong interest covers and operating margin

» Low debt, forecast to remain aligned with that of highest-rated peer group

» Supportive institutional framework in England

Credit challenges

» Reduced but material swap portfolio mitigated by the strength of its treasury policy

Rating outlook

The stable outlook on Midland Heart reflects the currently stable operating environment in addition to the group's stable and predictable strategy supporting reliably strong financial metrics.

Factors that could lead to an upgrade

An upgrade would be challenging given the proximity to the UK sovereign. However, a combination of the following could have positive rating implications: operating margin sustained above 35%, interest cover ratios sustained above 3.0x, and gearing maintained below 25%.

Factors that could lead to a downgrade

Negative pressure could arise from a material scaling up of the development programme driving higher than projected debt, a significant increase in market sales activity, a material weakening of interest cover ratios, or a shift to a more opportunistic strategy resulting in lower or less predictable cash flows. In addition, a weaker regulatory framework or a dilution of the overall level of support from the UK government could also exert downward pressure on the rating.

Key indicators

Exhibit 2

Midland Heart

	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22 (F)	31-Mar-23 (F)
Units under management (no.)	30,955	31,434	33,332	33,169	33,324	32,330	33,266
Operating margin, before interest (%)	31.9	35.4	30.9	30.5	30.9	29.3	28.5
Net capital expenditure as % turnover	(4.7)	8.0	11.9	20.8	25.1	53.4	29.3
Social housing letting interest coverage (x times)	2.3	2.3	2.5	2.4	1.9	2.5	2.2
Cash flow volatility interest coverage (x times)	2.3	2.4	2.6	2.7	2.4	2.8	2.6
Debt to revenues (x times)	2.7	2.9	2.4	2.6	2.9	2.7	3.1
Debt to assets at cost (%)	35.5	33.4	31.8	29.2	29.8	31.4	32.9

Source: Midland Heart, Moody's Investors Service

Detailed credit considerations

Midland Heart's A1 rating combines a Baseline Credit Assessment (BCA) of a2, with (1) our assessment of the very high default dependence between the group and the UK government, and (2) a strong likelihood of extraordinary support in the event that the entity faces acute liquidity stress.

Baseline credit assessment

Strong financial management, with a focus on low-risk social housing activities

Midland Heart exhibits strong financial management, with modest risk appetite and a focus on low-risk social housing lettings (SHL). Social housing lettings (SHL) accounted for 90% of turnover in fiscal 2021 compared to a rated peer median of 80%. The focus on traditional social housing will continue with an average of 87% of income from social housing lettings over the next three years. For fiscal 2021, other income sources included a small percentage of market sales at 5%, and minimal income from market sales and care activities.

Midland Heart's development programme is also focused on social housing. The group intends to develop around 3,400 units over the next five years with a tenure mix of: affordable housing (60%), shared ownership (31%), general needs (8%) and supported housing (1%).

The group's credit profile also benefits from its strong governance and management as evidenced by its strategic predictability and very stable financial metrics. In addition, financial management is governed by three golden rules which have been unchanged and adhered to consistently for years which underpins a clear risk framework for the group. Golden rules include (1) gearing maintained below 70%, (2) interest cover above 150%, and (3) a minimum of 18 months of forecast cash requirements, net of development sales.

Healthy financial performance, with strong interest covers and operating margin

Midland Heart will continue to maintain strong and stable financial performance. The group's operating margin was 31% for fiscal 2021 compared to a rated-peer median of 24%. Profitability is expected to remain strong over the next three years, with operating margins near 30%, supported by management's commitment to efficiency, inflation-linked rents and limited exposure to lower-margin market sales activity.

In line with other rated HAs, Midland Heart's social housing letting (SHL) operating margin has fallen over the last five years, largely driven by the rent cut, but remains strong. SHL operating margin was 33% in fiscal 2021 compared to a rated peer median of 31%, down from 40% three years earlier. In addition to the impact of the rent cut, Midland Heart has invested in digitisation and improved customer service. The SHL margin will remain stable near 31% for the next three years, providing the foundation for the strong overall group profitability.

The group will also maintain above average interest cover ratios. Midland Heart's social housing letting interest cover (SHLIC) stood at 1.9x in fiscal 2021 and its cash flow volatility interest cover (CVIC) was 2.4x. Both ratios were lower in 2021 due to a one-off £7.5 million interest cost associated with repayment of high cost legacy debt. We expect both to recover going forward and remain broadly aligned with A1-peer medians, with SHLIC averaging 2.3x over the next few years and CVIC 2.7x.

Low debt metrics, forecast to remain aligned with that of highest-rated peer group

Midland Heart's moderate development programme combined with its track record of high profitability has resulted in strong debt metrics which we expect to continue despite a planned increase in debt to fund development.

The group's debt stood at £576 million in fiscal 2021 and is expected to increase to £755 million by fiscal 2024. Midland Heart has £150 million of retained bonds which it plans to draw over the next two years. Despite the increase, gearing (debt to assets) and debt to revenues will remain strong. Gearing stood at 30% in fiscal 2021 and will grow by 3 to 4 percentage points over the next few years compared to a rated peer median of 48% (fiscal 2021). Debt to revenues will also remain robust, averaging 3.0x over the next three years compared to a rated peer median of 4.3x (fiscal 2021).

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong institutional framework governing English housing associations (HAs) reflected in an Operating Environment score of a2 and a Regulatory Framework score of a1. These scores are assigned at a national level and reflect the following credit considerations:

The English regulator maintains strong oversight through quarterly returns, long-term business plans, annual reviews, and by undertaking biennial In-Depth Assessments (IDAs) for large and complex HAs. In response to the pandemic, the regulator adapted some aspects of its oversight temporarily, for example, extending its liquidity monitoring, briefly pausing the programme of IDAs and delaying regulatory submissions to reduce the operational burden on HAs. The regulator has a strong track record of intervention in cases of mismanagement or financial stress with powers to provide financial assistance and/or make manager appointments where there has been a breach of regulatory standards.

The operating environment for English HAs has improved under more supportive policies for social rent increases and capital grant. Following four years of social rent reductions, HAs now benefit from a return to inflation-linked rent increases from April 2020 for five years. In addition, the government has committed to increased capital grant on more flexible terms for new social housing. Counterbalancing the improvements, we expect policy to drive increased borrowing and development risk in the sector as it responds to the government's objective to deliver a significant increase in the construction of new homes.

Reduced but material standalone swap portfolio mitigated by the strength of its treasury policy

Midland Heart's interest rate risk is aligned with peers but it has a material exposure to standalone swaps, exposing it to liquidity risks associated with collateral posting. As of September 2021, 80% of Midland Heart's debt was at fixed rates. The group has £321 million of property security pledged against its drawn loans and swap positions, which covered a negative mark to market position of £69 million in July 2021. The association's treasury policy requires Midland Heart to have sufficient security charged to cover a 50 basis point decline in interest rates, reflecting strong debt management.

We see Midland Heart's liquidity policy as a strength of the organisation and a supporting factor in its high investment and debt management score. The policy outlines that cash flow should be managed such that sufficient liquidity is always available to cover 18 months' cash flow, including all committed developments but excluding any development sales income. This policy effectively eliminates the entity's dependence on sales proceeds in managing liquidity, a credit positive.

As of July 2021, immediately available liquidity totaled £243 million, consisting of immediately available undrawn facilities of £152 million and £91 million of cash and cash equivalents. At fiscal year end 2021, Midland Heart's liquidity coverage was a strong 1.4x the HA's net capital requirements over the next two years. Moreover, the group will retain a strong level of unencumbered assets which stood at £402 million (MVT basis) at July 2021.

Extraordinary support considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers of redressal available to the regulator in case of financial distress, with the possibility of a facilitated merger or a transfer of engagements. Recent history has shown that the UK government is willing to support the sector, as housing remains a politically and economically sensitive issue. The strong support assumption also factors in the increasing exposure to non-core social housing activities in the sector, which add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more difficult. In addition, our assessment that there is a very high default dependence between Midland Heart and the UK government reflects their strong financial and operational links.

ESG considerations

How environmental, social and governance risks inform our credit analysis of Midland Heart

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Midland Heart, the materiality of ESG to its credit profile is as follows:

Environmental considerations are material to Midland Heart's credit profile. Although physical climate risks such as flood risk are unlikely to be material to HAs' credit profiles as they are managed by government authorities, energy efficiency and decarbonisation more broadly are becoming increasingly acute priorities for HAs with a target of all homes obtaining an energy performance certificate (EPC) of C or above by 2030 in England. Reaching this target will require material capex which would either divert cash flows away from development programmes or increase debt levels. As of December 2021, Midland Heart estimates 64% of its properties are rated EPC C or higher.

Social risks are material to HAs' credit profiles. In particular, the sector is exposed to risks stemming from socially-driven policy agendas affecting social rents, benefits and capital grants in addition to the impact of demographic trends on demand which are captured in our assessment of the operating environment. HAs are also impacted by customer relations and product quality. The Grenfell fire tragedy in June 2017 has encouraged higher health and safety standards with many HAs planning on increasing spending on the quality of their existing stock.

Governance considerations are also material to HAs' credit profiles and are captured in our assessment of governance and management. In general, housing association governance is strong with multi-year strategies supported by detailed forecasts, conservative liquidity policies, and robust risk management including stress testing.

Further details are provided in the "Baseline credit assessment" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

Rating methodology and scorecard factors

The assigned BCA of a2 is the same as the scorecard-suggested BCA.

The methodologies used in this rating are the European Social Housing Providers, published in April 2018, and Government-Related Issuers, published in February 2020.

Exhibit 3
Midland Heart's 2021 scorecard

Midland Heart			
Baseline Credit Assessment	**Sub-factor Weighting**	**Value**	**Score**
Factor 1: Institutional Framework			
Operating Environment	10%	a	a
Regulatory Framework	10%	a	a
Factor 2: Market Position			
Units Under Management	10%	33,324	a
Factor 3: Financial Performance			
Operating Margin	5%	30.9%	a
Social Housing Letting Interest Coverage	10%	1.9x	a
Cash-Flow Volatility Interest Coverage	10%	2.4x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	2.9x	a
Debt to Assets	10%	29.8%	a
Liquidity Coverage	10%	1.4x	a
Factor 5: Management and Governance			
Financial Management	10%	a	a
Investment and Debt Management	10%	a	a
Scorecard - Indicated BCA Outcome			**a2**
Assigned BCA			**a2**

Source: Midland Heart, Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
MIDLAND HEART	
Outlook	Stable
Issuer Rating -Dom Curr	A1
MIDLAND HEART CAPITAL PLC	
Outlook	Stable
Senior Secured -Dom Curr	A1

Source: Moody's Investors Service

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