MOODY'S
INVESTORS SERVICE

CREDIT OPINION
26 October 2023

Update

Send Your Feedback

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.

Contacts

Zoe Jankel +44.20.7772.1031
VP-Sr Credit Officer
zoe.jankel@moodys.com

Jeanne Harrison +44.20.7772.1751
Vice President - Senior Credit Officer
jeanne.harrison@moodys.com

Adam Chwojnicki +44.20.7772.8778
Ratings Associate
adam.chwojnicki@moodys.com

Sebastien Hay +34.91.768.8222
Associate Managing Director
sebastien.hay@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Midland Heart (United Kingdom)

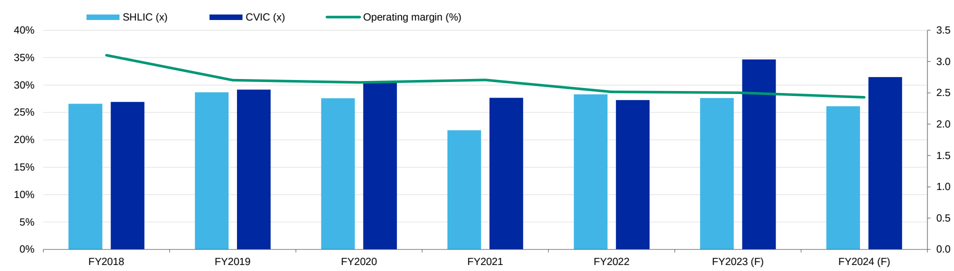
Update following outlook change to stable from negative

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 healthy interest covers and margins are expected to remain stronger than peers
Social housing lettings interest cover (x, RHS), cash flow volatility interest cover (x, RHS), operating margin (%, LHS)



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 reflects the expected gradual reduction in inflation and associated cost pressures as well as the proactive actions taken by the issuer to mitigate the adverse effects of the weaker operating environment.

Factors that could lead to an upgrade

Upward pressure on the ratings could result from a significant improvement in operating performance, a material reduction in debt or a significant increase in government support for the sector.

Factors that could lead to a downgrade

Downward pressure on the ratings could result from a prolonged weakening in operating performance, debt growing more quickly than forecasts, weaker liquidity or a failure to adapt strategies and risk appetite to mitigate weaker economic conditions. Lower government support for the sector or a dilution of the regulatory framework could also lead to downward pressure on the ratings.

Key indicators

Exhibit 2

Midland Heart

	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22	31-Mar-23 (F)	31-Mar-24 (F)
Units under management (no.)	31,434	33,332	33,169	33,324	33,877	34,230	35,080
Operating margin, before interest (%)	35.4	30.9	30.5	30.9	28.8	28.6	27.8
Net capital expenditure as % turnover	8.0	11.9	20.8	25.1	45.9	28.6	30.1
Social housing letting interest coverage (x times)	2.3	2.5	2.4	1.9	2.5	2.4	2.3
Cash flow volatility interest coverage (x times)	2.4	2.6	2.7	2.4	2.4	3.0	2.8
Debt to revenues (x times)	2.9	2.4	2.6	2.9	3.1	2.9	3.0
Debt to assets at cost (%)	33.4	31.8	29.2	29.8	29.7	30.8	33.0

Source: Midland Heart, Moody's Investors Service

Detailed credit considerations

On 25 October 2023, Moody's changed the outlook to stable from negative and affirmed the ratings for Midland Heart. The change in outlook followed Moody's change in outlook of the Government of the United Kingdom's Aa3 rating to stable from negative on 20 October 2023.

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 88% of turnover in fiscal 2022 compared to a rated peer median of 76%. The focus on traditional social housing will continue with an average of 89% of income from social housing lettings over the next three years. For fiscal 2022, other income sources included a small percentage of market sales at 8%, and minimal income from care activities.

Midland Heart's development programme is also focused on social housing. The group intends to develop around 3,280 units over the next five years with a tenure mix of: affordable housing (58%), shared ownership (32%) and general needs (10%).

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 29% for fiscal 2022 compared to a rated-peer median of 23%. Profitability is expected to remain strong over the next three years, albeit softening slightly, with operating margins averaging 28%, supported by management's commitment to efficiency, prudent planning 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 30% in fiscal 2022 compared to a rated peer median of 29%, down from 40% four years earlier. In addition to the impact of the rent cut, Midland Heart has invested in digitisation and improved customer service. Despite the 7% rent cap, SHL margin is projected remain stable near 30% 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 2.5x in fiscal 2022 and its cash flow volatility interest cover (CVIC) was 2.4x. The ratios increased in 2022 following a one-off £7.5 million interest cost in fiscal 2021 associated with repayment of high cost legacy debt. We expect SHLIC to decline modestly but remain broadly aligned with the A1-peer median, with SHLIC averaging 2.2x over the next three years but CVIC is projected to strengthen to 2.9x as cash flows rise due to an increase in creditors.

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 £642 million in fiscal 2022 and is expected to increase to £836 million by fiscal 2025. Midland Heart sold £75 million in retained bonds in February 2022, with a further £75 million remained to be drawn at a later date. Despite the increase, gearing (debt to assets) and debt to revenues will remain strong. Gearing stood at 30% in fiscal 2022 and will grow to 38% by fiscal 2027, compared to a rated peer median of 49% (fiscal 2022). Debt to revenues will also remain robust, averaging 3.1x over the next three years compared to a rated peer median of 4.1x (fiscal 2022).

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 a3 and a Regulatory Framework score of a1. These scores are assigned at a national level and reflect the following credit considerations:

The 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. 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 remains supportive. Demand for social housing remains very high and the government has committed to increased capital grant on more flexible terms for new social housing. English HAs retain some expenditure flexibility and have a track record of reducing costs to mitigate lower income.

However, due to presently very high rates of inflation, the government has intervened on social rent policy with a 7% ceiling on social rent increases to be implemented from April 2023 for a minimum of one year. The ceiling of 7% will likely result in an adverse differential between rental income and cost growth, driving lower margins and interest coverage. The intervention introduces policy volatility to the sector as the ceiling will supersede the allowable increase of consumer price inflation (CPI) plus 1% under the current rent standard, which is in place until March 2025.

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 June 2022, 80% of Midland Heart's debt was at fixed rates. The group has £308 million of property security pledged against its drawn loans and swap positions, which covered a negative mark to market position of £35 million in July 2022. 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 2022, immediately available liquidity totaled £288 million, consisting of immediately available undrawn facilities of £151 million and £137 million of cash and cash equivalents. At fiscal year end 2022, Midland Heart's liquidity coverage was a strong 2.2x of 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 £599 million (MVT basis) at July 2022.

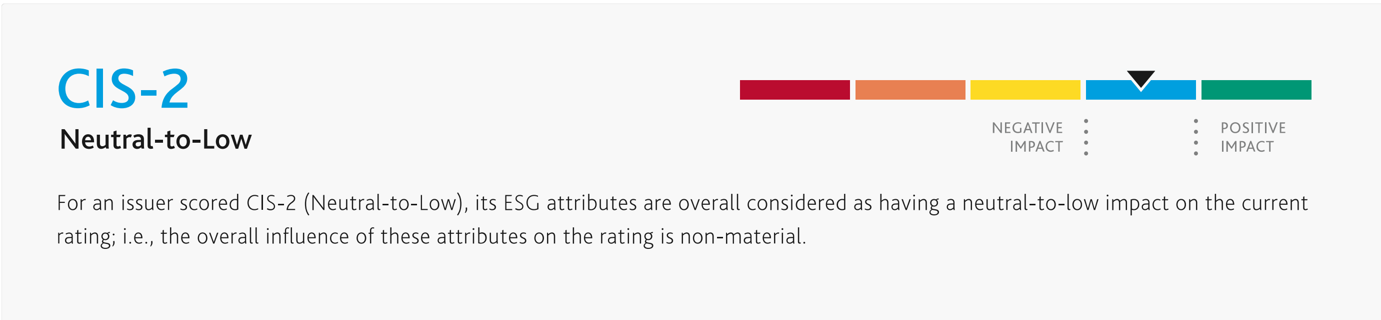
Extraordinary support considerations

The strong level of extraordinary support factored into the rating reflects the wide-ranging powers available to the regulator in cases of financial distress, with the possibility of a facilitated merger or a transfer of engagements. However, the process can be protracted and is reliant on HAs agreeing to merge, which could be more challenging in a weakening operating environment. 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 increasing exposure to non-core social housing activities in the sector, that add complexity to HA operations, and the weakening of the sovereign's financial resilience, making an extraordinary intervention slightly more challenging. 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 linkages.

ESG considerations

Midland Heart's ESG Credit Impact Score is Neutral-to-Low CIS-2

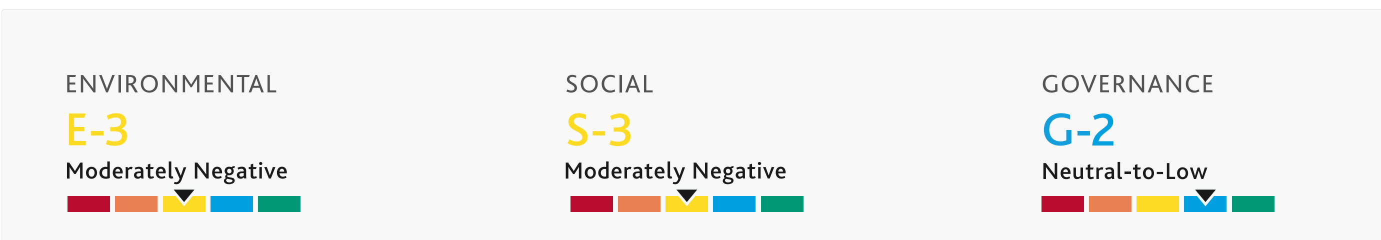
Exhibit 3
ESG Credit Impact Score



Source: Moody's Investors Service

Midland Heart's **CIS-2** indicates that ESG risks have a limited impact on its rating. Midland Heart has limited exposure to carbon transition risks as the majority of its stock already meets energy efficiency requirements, and although social risks are prevalent we consider that it has the ability to effectively mitigate them through its strong governance and management practices. We also consider that the supportive regulatory framework for the sector offsets some ESG risks.

Exhibit 4
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Midland Heart's exposure to environmental risks (**E-3**) relates to its material exposure to carbon transition risks as a relatively high proportion of its stock requires retrofit to meet EPC-C standards by 2035. This will increase capital expenditure over this time period, although we expect that this will be manageable due to its strong financial management practices.

Social

Midland Heart has material exposure to social risks (**S-3**) through sector-wide legislative requirements to improve the safety of existing housing stock (responsible production risks) which weighs on expenditure and operating margins, and the impacts of cost of living or affordability pressures on social tenants (demographic and societal trends) which led to the UK government capping social rent increases below inflation in fiscal 2024 in England, which will also have a negative impact on margins.

Governance

Midland Heart has limited governance risks (**G-2**). Its governance is fit for purpose with strong financial management policies and processes, detailed reporting and a simple organisational structure. The regulatory framework also supports good governance in the sector.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here] to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

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 5

Midland Heart's 2022 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%	33,877	a
Factor 3: Financial Performance			
Operating Margin	5%	28.8%	a
Social Housing Letting Interest Coverage	10%	2.5x	aa
Cash-Flow Volatility Interest Coverage	10%	2.4x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	3.1x	baa
Debt to Assets	10%	29.7%	a
Liquidity Coverage	10%	2.2x	aa
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: Moody's Investors Service, Midland Heart

Ratings

Exhibit 6

Category	Moody's Rating
MIDLAND HEART	
Outlook	Stable
Baseline Credit Assessment	a2
Issuer Rating -Dom Curr	A1
MIDLAND HEART CAPITAL PLC	
Outlook	Stable
Senior Secured -Dom Curr	A1

Source: Moody's Investors Service

REPORT NUMBER 1384663

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Moody's
INVESTORS SERVICE