MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
12 January 2021

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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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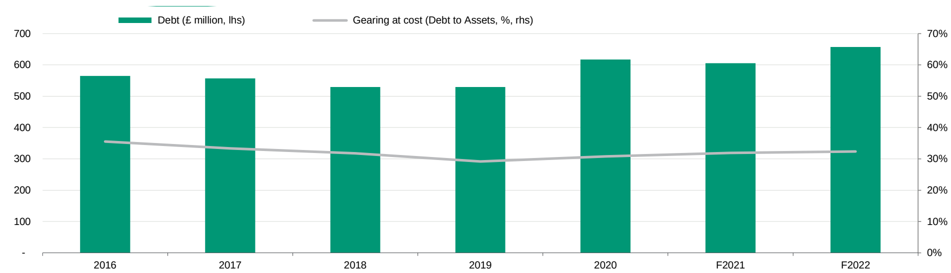
Midland Heart (United Kingdom)

Update to credit analysis

Summary

The credit profile of Midland Heart (A1 stable) reflects relatively low indebtedness, healthy operating performance and interest coverage ratios, as well as a large standalone swap portfolio and a moderate development programme. 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. We expect the coronavirus outbreak to cause ongoing operational disruption but limited credit impact.

Exhibit 1
Midland Heart's debt metrics to remain low and stable despite the expected debt increase



F - Forecast.
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 stable interest coverage and margins

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

» Supportive institutional framework in England

Credit challenges

» Moderate development programme, although primarily focused on affordable rent

» Large standalone swap portfolio mitigated by the strength of its treasury policy

Rating outlook

The stable outlook on Midland Heart reflects the currently stable operating environment, which is unlikely to undergo further material change in the medium term.

Factors that could lead to an upgrade

One or a combination of the following could have positive rating implications: (1) operating margin sustained above 35%; (2) further strengthening in interest cover ratios, with the social housing letting interest coverage (SHLIC) ratio sustained at or above 2.5x and the cash flow volatility interest coverage (CVIC) ratio sustained at or above 3.0x; (3) debt to revenue decreasing further to levels at or below 2.5x; and (4) a scaling back in development ambition, such that most of the development pipeline can be self-funded.

Factors that could lead to a downgrade

Negative pressure could arise from one or a combination of the following: (1) a material scaling up of growth aspirations, with increased exposure to commercial properties; (2) debt increasing above the projected levels; (3) weakening interest cover ratios, with SHLIC and CVIC sustained below 2.0x; and (4) a worsening in Midland Heart's strong liquidity position.

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-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Mar-20	31-Mar-21 (F)	31-Mar-22 (F)
Units under management (no.)	31,008	30,955	31,434	33,332	33,169	33,432	34,272
Operating margin, before interest (%)	24.7	31.9	35.4	30.9	30.5	29.8	29.3
Net capital expenditure as % turnover	6.8	(4.7)	8.0	11.9	20.8	34.9	24.3
Social housing letting interest coverage (x times)	1.8	2.3	2.3	2.5	2.4	2.5	2.4
Cash flow volatility interest coverage (x times)	2.1	2.3	2.4	2.6	2.7	3.0	3.0
Debt to revenues (x times)	2.7	2.7	2.9	2.4	2.6	3.1	2.7
Debt to assets at cost (%)	37.7	35.5	33.4	31.8	29.2	30.8	31.9

Fiscal 2016-20 Midland Heart financial statements; fiscal 2021-22 Midland Heart business plan.
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 low risk appetite and a clear business focus on being a traditional social landlord. Social housing letting (SHL) activities are expected to represent 87% of turnover on average over the next three years, in line with an average of 85% between fiscal 2017 and fiscal 2020, as the HA exits non-core activities and has moderate exposure market sales through shared ownership. Geographically, operations are concentrated in both the West and East Midlands, with housing stock concentrated in five local authorities and activities that expand to 54 councils. The HA is examining opportunities for swapping units that are located far from core areas of operations, as part of its asset management programme, to further concentrate its geographical focus and enhance tenant engagement.

Midland Heart's development ambition continues to focus on SHL, with the HA planning to deliver over 2,300 social and affordable rented units throughout its five-year development plan (72% of the five-year development pipeline).

A key feature of Midland Heart's financial management is its three golden rules, according to which (1) gearing (total loans as a percentage of social housing grant plus reserves) should be below 70%, (2) interest cover should be above 150%, and (3) a minimum of 18 months of forecast cash requirements should be maintained, net of development sales. The adherence to and regular monitoring of these rules is a supportive element of Midland Heart's credit profile.

Healthy financial performance, with stable interest coverage and improved margins

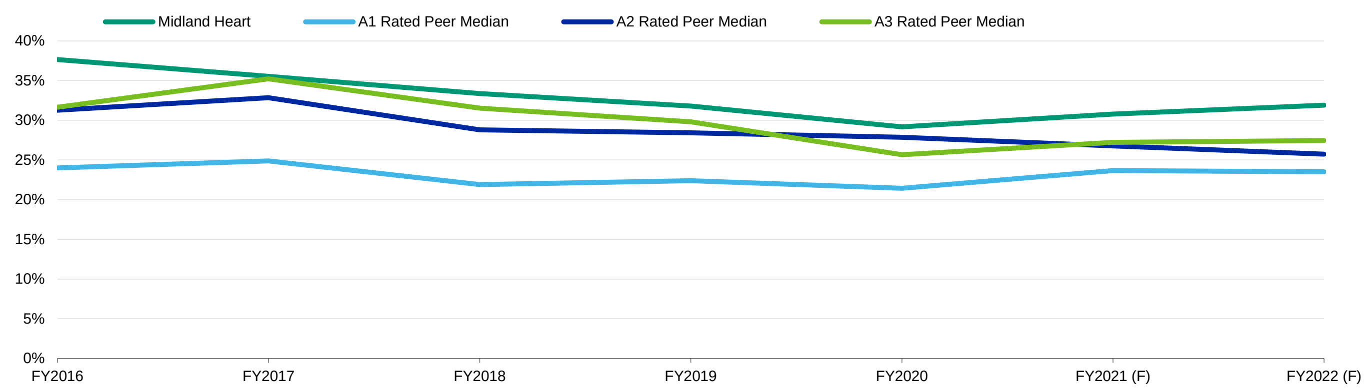
We expect Midland Heart's strong operating margin, 31% in fiscal 2020, corresponding to a record operating surplus of £86 million, to continue over the next three years, supported by the management's commitment to efficiency. The HA achieved significant savings with its previous corporate plan (Fit for Future), which it completed a year early, allowing Midland Heart to register the highest operating margin amongst A1-rated peers (median of 22% in fiscal 2020). Midland Heart's commitment to efficiency is illustrated through its decreased rent arrears (4.5% in fiscal 2020), and re-let times (20 days), both metrics in line with the sector medians. Although arrears are expected to increase in fiscal 2021 due to the economic impact of the coronavirus pandemic, we expect this increase will be offset by savings on management expenses, repairs and delays in recruitment.

The HA's current corporate plan "Making what matters brilliant" looks to utilise Midland Heart's strong financial position in order to deliver an increased number of social and affordable homes, growing to a planned 650 new homes built on average per year, from 570 built in 2020. As the 2020 nationwide lock-down delayed deliveries in fiscal 2021, Midland Heart extended its corporate plan by one year. The HA is now planning to deliver 4,000 new homes in six years instead of c.3,000 in five years. Through investment in digitalization and improved customer service, Midland Heart aims to increase customer satisfaction, repairs, reducing voids and bad debts while continuing to record strong performance. The HA's withdrawal from care contracts will marginally lower revenues but it will also generate savings, supporting profitability.

Exhibit 3

Midland Heart to retain the highest profitability amongst A1-rated peers

Operating margin, %



F : Forecast

Source: Midland Heart, Moody's Investors Service

Midland Heart's focus on core operations is reflected in the HA's strong SHLIC ratio, which has continued to strengthen driven by the HA coming out of high-cost legacy loans and improved profitability of its core general needs business. Midland Heart's SHLIC stood at 2.4x in fiscal 2020, amongst the highest SHLIC in our rated portfolio, and will remain stable over the next three years. The HA's moderate development programme is primarily focused on the provision of affordable rent, which gives Midland Heart the benefit of very stable and predictable cash flow, and is reflected in the group's strong CVIC ratio of 2.7x in fiscal 2020, which we expect to strengthen to 3.0x across the next three years.

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

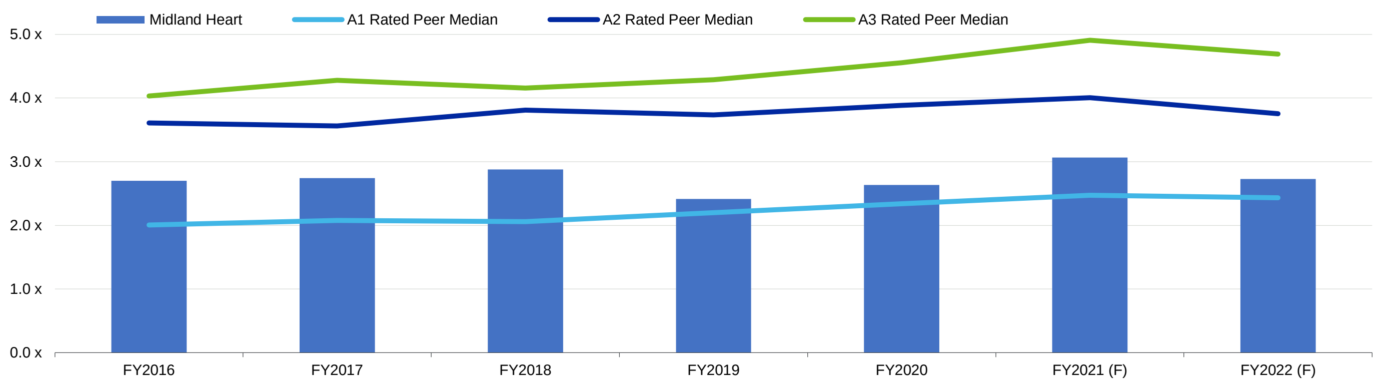
After 5 years of deleveraging, Midland Heart's debt is expected to rise to £617 million in fiscal 2021, from £529 million in fiscal 2020, following the issuance in August 2020 of a £100 million bond[1]. Despite the 17% debt increase, Midland Heart's leverage remains sustainable, with debt to revenues to growing to 3.1x and gearing (debt to assets at cost) to 31% in fiscal 2021.

While Midland Heart's current committed development pipeline is fully funded by existing facilities and cash reserves, a key credit strength, additional borrowing over the medium term is required to fund its planned development programme of around 650 homes per annum. Debt is forecast to reach £658 million by fiscal 2023, but the group's debt metrics are expected to remain stable, with debt to revenues averaging 2.9x over the next three years and gearing averaging to 32% over the same period. This is broadly in line with A1-rated peers (medians of 2.5x and 37% over the same period) and compares favourably with all rated HAs (medians of 4.2x and 50% over the same period).

Exhibit 4

Midland Heart's leverage will remain in line with A1-rated peers despite the 2021 debt increase

Debt-to-revenues, x times



F : Forecast.

Source: Midland Heart, Moody's Investors Service

Supportive institutional framework in England

The sector's credit quality will continue to benefit from the strong regulatory framework governing English HAs. 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. 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.

Moderate development programme, although primarily focused on affordable rent

Midland Heart's net capital spending is expected to increase slightly over the next three years to 24% of turnover, versus 21% in fiscal 2020. This increase remains moderate compared to peers (median of 29% for A1-rated peers, 37% for all rated HAs). The rise in capital spending is driven by Midland Heart's ambition to register among the top 20 associations in the UK for new homes built for affordable and social rent.

The development programme includes a target of delivering around 650 new build properties per annum over the next 5 years, with 72% affordable and social rent and 28% shared ownership. The exposure to market sales will slightly increase in the three next years, to 9% in average versus 7% in fiscal 2020. We view Midland Heart's exposure to market sales as moderate (which we define as in between 5% and 20% of turnover).

While we note the planned volume of development activity is higher than the scale in Midland Heart's previous business plan, the tenure mix remains largely unchanged and represents a structurally different approach to rated peers. With a sector that is actively increasing its exposure to market sales, Midland Heart has differentiated itself by focusing on the growth of its core social and affordable rented properties. Midland Heart's outright sale units have all been sold in fiscal 2020 (representing 1% of turnover) and no further development in this tenure is being considered. Any future outright sale developments will be identified on a scheme-by-scheme basis.

Large standalone swap portfolio mitigated by the strength of its treasury policy

As of fiscal 2020, 79% of Midland Heart's debt was at fixed rate. Standalone swaps have been used to synthetically fix £150 million of the group's debt portfolio, exposing it to liquidity risks associated with collateral posting. Midland Heart's has £321 million of property security pledged against its drawn loans and swap positions, which accounted for a negative mark to market position of £82 million in September 2020. These properties pledged provide a significant buffer against adverse interest rate movements. 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 note that the current security buffer pledged would be able to withstand a decline in interest rates to 2 percentage points across the duration of the swaps.

We see Midland Heart's liquidity policy as a key credit 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. Liquid assets totaled £327 million, consisting of immediately available undrawn facilities of £153 million and £174 million of cash and cash equivalents as of September 2020. At fiscal year end 2020, Midland Heart held sufficient liquidity to cover 1.9x the HA's net capital requirements over the next two years, which adequately covers the planned increase in capital spending on development over this period.

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 not material to HAs' credit profiles. In line with the rest of the UK, the sector's main environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by county and national authorities, and therefore the financial burden of adapting to increased flood risk will not fall on individual housing associations.

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. We view the coronavirus outbreak as a social risk under our ESG framework given its impact on health and safety. Overall, we expect the outbreak to cause ongoing operational disruption for HAs but do not expect a material credit impact as higher arrears and lower market sales receipts will be offset by cash savings from reduced capital spending on development and repairs. 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 closed to 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

Fiscal 2020 Midland Heart

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%	33,169	a
Factor 3: Financial Performance			
Operating Margin	5%	30.5%	a
Social Housing Letting Interest Coverage	10%	2.4x	aa
Cash-Flow Volatility Interest Coverage	10%	2.7x	a
Factor 4: Debt and Liquidity			
Debt to Revenue	5%	2.6x	a
Debt to Assets	10%	29.2%	a
Liquidity Coverage	10%	1.9x	a
Factor 5: Management and Governance			
Financial Management	10%	a	a
Investment and Debt Management	10%	a	a
Suggested BCA			**a1**

Source: Moody's Investors Service

Ratings

Exhibit 6

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

Endnotes

1 £250 million bond with bullet maturity of 30 years, including £150 million retained

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