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CREDIT OPINION
8 December 2022

Update

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RATINGS
Midland Heart

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

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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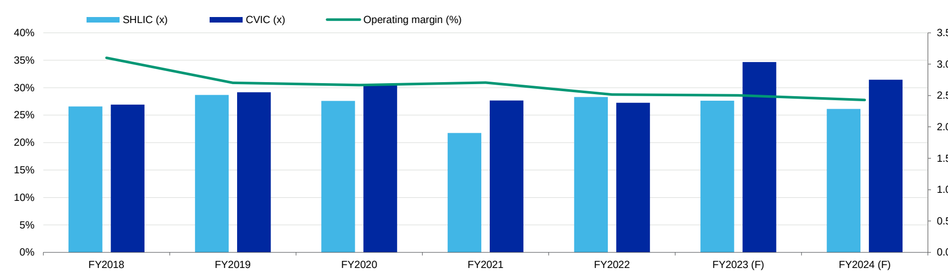
Midland Heart (United Kingdom)

Update to credit analysis

Summary

The credit profile of Midland Heart (A1 negative) 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 negative) 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 negative outlook reflects the high exposure to weaker economic and financial conditions in the UK. The 7% ceiling on social rent increases imposed in England combined with high cost inflation will weigh on operating margins over the next 12 to 18 months. At the same time, rising interest rates and tightening financing conditions will further weaken interest coverage ratios.

Factors that could lead to an upgrade

A rating upgrade is unlikely due to the negative outlook. The negative outlook could be stabilised if Midland Heart is able to maintain relatively stable financial metrics over the medium term. This could be driven by improving operating performance including the ability to contain cost pressures or a reduction in development leading to lower debt levels than previously anticipated. 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

The ratings could be downgraded as a result of one or a combination of the following: a failure to adapt strategy to mitigate against weaker economic conditions; a sustained weakening in operating margins and interest coverage; increases in debt beyond that currently anticipated; significant deteriorations in liquidity; significant scaling up in market sales exposure; or any weakening of the regulatory framework or dilution of the overall level of support from the UK government. A downgrade of the UK sovereign rating would also place 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

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

CIS-2
Neutral-to-Low

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody's Investors Service

Moderately negative exposure to environmental risks due to carbon transition risks caused by the legislative requirement to improve the energy efficiency of existing housing stock. Moderately negative exposure to social risks due to legislative requirements to improve the safety of existing housing stock, and the vulnerability of the sector to changing government policy to improve affordability to low-income demographics through its rent setting, including a 7% ceiling on social rent increases. Low exposure to governance risks due to good standards of management and governance and supportive regulatory framework.

Exhibit 4
ESG Issuer Profile Scores

ENVIRONMENTAL
E-3
Moderately Negative

SOCIAL
S-3
Moderately Negative

GOVERNANCE
G-2
Neutral-to-Low

Source: Moody's Investors Service

Environmental

Moderately negative exposure to environmental risks, primarily due to carbon transition risk from the legislative requirement for English housing associations to improve the energy efficiency of their existing housing stock by 2035, leading to increased expenditure. We consider that Midland Heart has a material exposure to this risk due to a relatively high proportion of its stock requiring retrofit.

Social

Moderately negative exposure to social risks. This is due to moderately negative exposure to responsible production risks and demographic and societal trends risks. Responsible production risks include the legislative requirement to improve the safety of its existing housing stock which will increase expenditure over the medium term. Demographic and societal trends risks reflect the vulnerability of the sector to tenant affordability challenges and to government policy which controls rent setting in England and Wales, which weighs on revenue. The government's recent intervention on social rent policy with a 7% ceiling on social rent increases from April 2023 introduces policy volatility to the sector and will have a negative impact on financial performance.

Governance

Limited exposure to governance risks. Governance in the sector is generally fit for purpose, with good oversight of business risks, strong financial planning and risk management processes, detailed reporting and simple organisational structures. 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	Negative
Baseline Credit Assessment	a2
Issuer Rating -Dom Curr	A1
MIDLAND HEART CAPITAL PLC	
Outlook	Negative
Senior Secured -Dom Curr	A1

Source: Moody's Investors Service

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