Research Update:

U.K.-Based Paragon Asra Housing Downgraded To 'BBB+' On Weaker Performance; Outlook Stable

June 27, 2023

Overview

- We forecast that Paragon Asra Housing Ltd.'s (PA Housing's) increasing investment in its existing homes will significantly weaken its financial metrics more than we had previously forecast.
- The impact on the group's financial performance will likely be mitigated by grants and other recoveries, but we project the group's S&P Global Ratings-adjusted EBITDA margins will remain subdued.
- Although we understand that the group is scaling back on its partially debt-funded development program, we think it will nevertheless exacerbate our forecast weakening of its debt metrics.
- We therefore lowered our issuer credit rating on PA Housing to 'BBB+' from 'A-' and assigned a stable outlook.

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Rating Action

On June 27, 2023, S&P Global Ratings lowered its long-term issuer credit rating on Paragon Asra Housing Ltd. (PA Housing) to 'BBB+' from 'A-'. The outlook is stable.

We also lowered our issue ratings on the £250 million and £400 million senior secured bonds issued by PA Housing's funding vehicle, Paragon Treasury PLC, to 'BBB+' from 'A-'. We consider that Paragon Treasury PLC was set up for the sole purpose of issuing bonds and lending the proceeds to the group, and we view it as a core subsidiary of PA Housing.

Outlook

The stable outlook reflects our view that the management's commitment to contain costs, especially investments in fire safety, will limit further downside pressure on the group's financial metrics.

Downside scenario

We could lower the rating on PA Housing if the management deviates from its current strategies and policies, resulting in additional risks that lead to financial metrics materially weaker than our current base case. This could happen, for example, if the management failed to contain the costs on property maintenance and new home development.

Upside scenario

We could raise the rating if the management is able to manage cost pressures, such that PA Housing's adjusted EBITDA margin improves markedly and faster than we currently forecast. We would also expect this to significantly improve the group's debt metrics.

Rationale

The downgrade reflects our forecast that PA Housing's financial metrics will further weaken because of its elevated investments in its existing assets being extended for a longer period than previously projected. We understand that a substantial amount of these additional costs comes from fire safety remedial works and estimate that these works will incur higher costs and last longer than we had previously forecast. We expect that claims from the Building Safety Fund and potential settlements with relevant contractors could partly offset these costs, although we consider that these recoveries remain uncertain, especially in terms of timing and size. As a result, we expect the group's adjusted EBITDA margins to be depressed below a modest level of about 20% over the coming two to three years, significantly lower than its historical level of about 30%.

We also project that the group's debt metrics will be under further stress due to the combination of lower non-sales-adjusted EBITDA and additional debt required to carry out ongoing development of new homes. We think that the group's actions to scale back its development targets will partly alleviate the pressure, but the debt metrics will be still vulnerable.

Enterprise Risk Profile: More focus on the core business but limited positive impact of management's actions to mitigate financial pressure

Although we understand that the group's current high level of remedial works to ensure fire safety for residents is a core part of its business, the management's planning and strategy about these costs will limit the group's financial capacities. We note that a new CEO has come in to lead the group to focus more on services to tenants while controlling the cost base to mitigate financial pressure. We think that the group is expediting the fire safety works by undertaking active negotiations with the contractors. Nevertheless, we expect that it will take some time for the group to successfully complete the remediation.

We expect that the group will remain focused on traditional social housing lettings, by delivering the majority of the new units as general needs units. We project the exposure to sales, which is contained to first-tranche shared ownership sales, will be limited at around 14% in the coming two to three years on average, reducing the group's exposure to sales risks.

PA Housing's portfolio--owning and managing more than 23,000 homes, primarily in London, Surrey, and the East Midlands--continues to experience strong demand and underpins our expectation of a highly predictable revenue stream. We estimate that the group's average social and affordable rents is about 62% of the market rent in its areas of operations, which supports demand for its homes. We consider that the group's vacancies are generally on par with the sector, at about 2.5% of rent and service charge receivables on a three-year average. We note that void loss has gradually reduced through the last fiscal year with an improvement in managing the shared ownership stock. We understand the group is progressing with its efforts to achieve an Energy Performance Certificate (EPC) rating of C on all existing rented homes. Currently, 73% of the stock already meets that target, which is above the sector average of just over 50%.

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 For Public And Nonprofit Social Housing Providers," published June 8, 2021.

Financial Risk Profile: High level of investment in existing assets further weakens the financial metrics below our previous forecast

We think that the group's higher total costs on fire safety works and extended timeline to achieve these works will result in thinner adjusted EBITDA margins than we had previously expected. Meanwhile, the group will still need to carry out its regular capital maintenance works and investments to upgrade its remaining properties that have not achieved the EPC rating of C or above. We therefore expect that these rising cost pressures will suppress the group's adjusted EBITDA margin below 20% in the coming two to three years.

We estimate that the group will need to largely fund its development program with debt, despite grant funding and very modest fixed-asset sales. The additional rental revenue from the new units to some extent helps strengthen the non-sales-adjusted EBITDA. However, we think that the elevated investment in existing homes will reduce the positive impact brought by these new units on the non-sales-adjusted EBITDA. Consequently, we anticipate the debt to non-sales-adjusted EBITDA will exceed 40.0x with non-sales-adjusted EBITDA interest coverage below 1.0x, and remaining around 0.6x by fiscal year ending March 31, 2026.

We view PA Housing's liquidity position as strong. Over the next 12 months, we expect the ratio of liquidity sources to uses will be below 1.7x. This is based on our forecast of liquidity sources of about £400 million--from cash, undrawn and available revolving credit facilities, asset sales, grant receipts, and cash from operations (adding back the noncash cost of sales)--which will cover liquidity uses of about £237 million (mainly capital expenditure and debt service payments). We continue to assess PA Housing's access to external liquidity as satisfactory.

Government-related entity analysis

We believe there is a moderately high likelihood that PA Housing would receive timely extraordinary support from the U.K. government, through the Regulator of Social Housing (RSH) in case of financial distress. This provides a two-notch uplift from the stand-alone credit profile. Given that one of the key goals of the 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 PA Housing.

Selected Indicators

Table 1

Paragon Asra Housing Ltd.--Key Statistics

	--Year ended March 31--				
Mil. £	**2022a**	**2023e**	**2024bc**	**2025bc**	**2026bc**
Number of units owned or managed	23,292	24,002	24,350	24,992	25,677
Adjusted operating revenue	163.5	175.0	193.1	209.7	227.7
Adjusted EBITDA	33.0	33.6	33.8	37.8	41.3
Non-sales adjusted EBITDA	27.2	28.6	27.3	29.7	30.4
Capital expense	132.6	192.9	167.0	157.0	136.3
Debt	994.0	1,083.1	1,174.9	1,295.7	1,395.3
Interest expense	33.4	40.6	41.4	46.5	51.2
Adjusted EBITDA/Adjusted operating revenue (%)	20.2	19.2	17.5	18.0	18.1
Debt/Non-sales adjusted EBITDA (x)	36.6	37.9	43.0	43.6	45.9
Non-sales adjusted EBITDA/interest coverage(x)	0.8	0.7	0.7	0.6	0.6

a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Ratings Score Snapshot

Table 2

Paragon Asra Housing Ltd.--Ratings Score Snapshot

	Assessment
Enterprise risk profile	**3**
Industry risk	2
Regulatory framework	3
Market dependencies	3
Management and Governance	4
Financial risk profile	**5**
Financial performance	5
Debt profile	6
Liquidity	3

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:

- Health and safety

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

- United Kingdom Outlook Revised To Stable From Negative On Moderating Fiscal Risks; 'AA/A-1+' Ratings Affirmed, April 21, 2023
- U.K. Social Housing Borrowing 2023: On Pause, March 28, 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
- Non-U.S. Social Housing Providers Ratings History: March 2023, March 27, 2023
- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022
- Non-U.S. Social 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
- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 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 For Public And Nonprofit Social Housing Providers, June 8, 2021

Ratings List

Downgraded

	To	From
Paragon Asra Housing Ltd.		
Issuer Credit Rating	BBB+/Stable/--	A-/Negative/--
Paragon Treasury PLC		
Senior Secured	BBB+	A-