S&P Global
Ratings

RatingsDirect®

Research Update:

U.K. Housing Provider Hexagon Housing Association Ltd. Downgraded To 'BBB+'; Outlook Stable

March 24, 2023

PRIMARY CREDIT ANALYST

Tim Chow
London
+44 2071760684
tim.chow
@spglobal.com

SECONDARY CONTACT

Karin Erlander
London
+ 44 20 7176 3584
karin.erlander
@spglobal.com

ADDITIONAL CONTACT

Sovereign and IPF EMEA
SOVIPF
@spglobal.com

Overview

- We forecast that English social housing provider Hexagon Housing Association Ltd.'s (Hexagon's) financial performance will weaken beyond our previous expectations due to increasing operating costs.
- While we understand that Hexagon will scale back its investments in existing stock and development of new homes, we are uncertain about the implementation and efficacy of its financial policies and strategies, and how effective management's actions would be in mitigating stress stemming from the volatile economic and regulatory environment.
- We therefore lowered our long-term rating on Hexagon to 'BBB+' from 'A-'.
- The outlook is stable.

Rating Action

On March 24, 2023, S&P Global Ratings lowered its long-term issuer credit rating on Hexagon to 'BBB+' from 'A-'. The outlook is stable.

We also lowered our long-term issue rating on Hexagon's £250 million senior secured bond to 'BBB+' from 'A-'.

Outlook

The stable outlook reflects our view that Hexagon is likely to be able to contain costs relating to investments in existing stock and that development of new homes will be contained such that the group's debt metrics will marginally improve toward the end of our three-year forecast period, while liquidity remains strong.

Downside scenario

We could lower the rating if, because of insufficient control over operating and development costs, Hexagon's financial performance and debt metrics did not improve as planned, with its liquidity position deteriorating.

We could also lower the rating if we thought that the likelihood of timely extraordinary support from the U.K. government to Hexagon had decreased.

Upside scenario

We could upgrade Hexagon if we perceived that its strategy had led to a sustained improvement of the credit metrics while addressing the need for investment in existing stock and new homes. This would likely result in the group's interest cover strengthening comfortably above 1x.

Rationale

The downgrade reflects our expectations that higher costs, partly because of inflation, will weaken the Hexagon's financial indicators more than we previously anticipated. We also understand that Hexagon's financial policy has become more short-term in focus. While the group is scaling back the development of new homes, we consider that in combination with the ongoing program's delays, Hexagon will see lower rental revenue than we had previously assumed. In our view, the group's sales activities will be postponed until later years, further reducing revenue compared with our previous base case. The combination of weaker S&P Global Ratings-adjusted EBITDA and a relatively large bond issue amid rising interest costs in 2022 has resulted in a higher debt burden. The group currently has a substantial amount of cash following the bond issuance, but we are mindful that this will diminish over time because of capital expenditure (capex). In addition, Hexagon no longer has any committed undrawn facilities in place. Still, we expect that the group's plan to reduce costs will partly offset the current pressures.

Hexagon owns and manages over 4,500 homes in southeast London. In our view, Hexagon benefits from generating most of its revenue in the predictable and noncyclical social-housing sector. We think that demand for Hexagon's properties will remain solid, because its social and affordable rent levels are low, averaging about 40% of the prevailing market rent. This is further demonstrated by Hexagon's vacancy rates, with voids of 1.6% on average over the past three years, which we consider on a par with the wider sector.

The group's management will need to balance the current development program with maintaining its housing services and stock quality. We are uncertain about the implementation and effectiveness of the group's financial and operational strategy over the medium term, and we consider that Hexagon has less financial and operational capacity than peers to absorb external shocks because of its relatively small size.

We expect that the group's spending on fire safety remediation, together with an increased operating cost base, will lower its adjusted EBITDA margins in 2023 beyond our previous base case, despite grant funding from the U.K. government's Building Safety Fund. We understand that this spending will decline as the group focuses on ongoing repairs over the next three years. In addition, Hexagon is reprofiling the investment in existing stock to cope with the current cost pressure. That said, we forecast that operating costs will remain high. Also, we think that the sale of units, which carry lower margins than the rental business, will suppress the financial performance.

We understand that the group is reducing its investment in new homes by pausing uncommitted developments that would otherwise have followed the current development program in the next two to three years. We forecast that the group will make use of the large cash holding from the bond issuance to fund development in new homes. However, we expect debt metrics will weaken compared with historical levels, because of weaker financial performance and a higher level of debt and interest payments. We view positively that the bond replaced the variable rate debts, which stabilizes the cost of debt and makes the group less exposed to the volatility of interest rates, albeit at a higher average cost of debt than in the past. Because of higher interest costs combined with the group's weakening financial performance, we predict that Hexagon's adjusted nonsales EBITDA interest cover will fall below 1x in the near term, from 2.2x in fiscal year ending March 31, 2022. Debt to nonsales adjusted EBITDA will surge above 30x at the same time, from below 20x in fiscal 2022.

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).

We think there is a moderately high likelihood that Hexagon would receive timely extraordinary government support in case of financial distress. Since one of the Regulator of Social Housing's (RSH) key goals is to maintain lender confidence and low funding costs across the sector, we think it is likely that the RSH would step in to try to 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 Hexagon. This currently provides two notches of uplift from the stand-alone credit profile.

Liquidity

We consider Hexagon's liquidity position to be strong, but see a risk that it will gradually decline as the group uses its cash to finance development. We estimate that Hexagon's sources of liquidity to uses over the next 12 months will be about 2.2x. Our assessment is further supported by our view that Hexagon will have satisfactory access to liquidity.

Sources of liquidity in the next 12 months include:

- Cash and liquid investments of close to £65 million;
- Cash flow from operations of close to £22 million, adding back noncash cost of sales; and
- Our expectation of proceeds from asset sales of close to £2 million.

Uses of liquidity over the same period include:

- Expected capex of close to £30 million; and
- Total interest and principal payments of above £10 million.

Key Statistics

Table 1

Hexagon Housing Association Ltd.--Key Statistics

	--Year ended March. 31--				
Mil. £	2021a	2022a	2023bc	2024bc	2025bc
Number of units owned or managed	4,491	4,478	4,502	4,579	4,697
Adjusted operating revenue	33.4	38.7	33.7	47.0	57.5

Table 1

Hexagon Housing Association Ltd.--Key Statistics (cont.)

	--Year ended March. 31--				
Mil. £	**2021a**	**2022a**	**2023bc**	**2024bc**	**2025bc**
Adjusted EBITDA	9.8	11.0	5.9	10.4	12.5
Nonsales adjusted EBITDA	9.6	10.4	5.8	9.5	11.2
Capital expense	5.7	14.0	28.0	29.8	13.0
Debt	206.7	207.4	307.2	306.8	306.3
Interest expense	4.7	4.6	10.8	10.8	10.8
Adjusted EBITDA/Adjusted operating revenue (%)	29.2	28.5	17.5	22.2	21.7
Debt/Nonsales adjusted EBITDA (x)	21.5	19.9	52.8	32.4	27.3
Nonsales adjusted EBITDA/interest coverage(x)	2.0	2.2	0.5	0.9	1.0

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

Hexagon Housing Association 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	4
Financial performance	4
Debt profile	5
Liquidity	2

S&P Global Ratings bases its ratings on nonprofit 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:

- Risk management, culture, and oversight

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: 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

- U.K. Social Housing Providers Set Their Sights On Cyber Risks, Dec. 16, 2022
- Non-U.S. Social Housing 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
- United Kingdom, Oct. 24, 2022
- The U.K. Social Housing Sector Now Displays A More Pronounced Negative Bias In Its Creditworthiness, Oct. 11, 2022
- Economic Outlook U.K. Q4 2022: Under The Pump, Oct. 3, 2022
- United Kingdom Outlook Revised To Negative On Rising Fiscal Risks; 'AA/A-1+' Ratings Affirmed, Sept. 30, 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
- Non-U.S. Social Housing Providers Ratings Risk Indicators: July 2022, July 27, 2022
- Non-U.S. Social Housing Providers Ratings History: July 2022, July 27, 2022
- Non-U.S. Social Housing Providers Ratings Score Snapshot: July 2022, July 27, 2022
- U.K. Social Housing Sector Borrowing Needs to Rise To Fund Investment In New Homes, March 31, 2022
- Global Regulatory Framework Report Card: Public And Nonprofit Social Housing Providers, June 8, 2021

Ratings List

Downgraded

	To	From
Hexagon Housing Assocation Limited		
Senior Secured	BBB+	A-

Downgraded; Outlook Action

	To	From
Hexagon Housing Assocation Limited		
Issuer Credit Rating	BBB+/Stable/--	A-/Negative/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914