S&P Global
Ratings

RatingsDirect®

Research Update:

U.K. Social Housing Provider Local Space 'AA-' Rating Affirmed; Outlook Stable

Primary Credit Analyst, Sovereigns And International Public Finance:
Jean-Baptiste Legrand, London (44) 20-7176-3609; jb.legrand@spglobal.com

Secondary Credit Analyst, Sovereigns And International Public Finance:
Ratul Sood, CFA, London +44 (0) 20 7176 6536; ratul.sood@spglobal.com

Table Of Contents

Research Update:

U.K. Social Housing Provider Local Space 'AA-' Rating Affirmed; Outlook Stable

Overview

- Local Space Ltd. (LS) is a U.K.-based social housing provider set up in 2006 with the objective to provide settled accommodation for homeless households in the east of London.
- In our view, LS continues to benefit from very strong enterprise and financial profiles, underpinned by a stable profitability margin that is larger than peers'.
- We are therefore affirming our 'AA-' long-term rating on LS.
- The stable outlook reflects our opinion that LS will continue to benefit from revenue growth through long-term leasing agreements, mitigating higher leverage induced by its development plan over the next four years (2017-2020).

Rating Action

On Feb. 3, 2017, S&P Global Ratings affirmed its 'AA-' long-term issuer credit rating on U.K-based social housing provider Local Space Ltd. (LS). The outlook remains stable.

Rationale

The affirmation reflects our continued assessment of LS's stand-alone credit profile (SACP) at 'aa-', supported by very strong enterprise and financial profiles, in our view.

The rating reflects the low industry risk under which LS operates along with its very strong economic fundamentals. Over 2014-2016, LS displayed very low voids and arrears that respectively accounted for less than 0.5% and 2% of LS' revenues--lower than the sector average--partly due to the strong and continuous housing demand in the area where LS operates. Additionally, LS benefits from long-term leasing agreements with local authorities in the Greater London area, such as the London Borough of Newham (LBN), London Borough of Hackney, and London Borough of Waltham Forest, which are marked by a guaranteed rent mechanism that is based on an annual rent increase that secures its revenue growth.

In March 2016, LS managed to extend its leasing agreement with LBN by 10 years to 2031 (the original agreement signed in 2006 was initially set to be terminated in 2021). We view this extension as a major supporting element of LS' creditworthiness, given that the agreement covers around 80% of LS' portfolio and would contribute to provide guaranteed rental revenue growth at an annual rate of 1% over the next 15 years. In particular, the terms of this agreement go against the current trend of rent cuts affecting the social housing sector as a consequence of decisions made by the U.K. central government. We expect social rents reduction will have a limited impact on LS, since only 93 out of more than 1,800 units will be affected, while the risk of increased arrears and bad debt brought about by the welfare reform changes will be borne by the local authority. In our opinion, these elements largely mitigate LS' relatively small portfolio size compared to the sector average with less than 2,000 housing units as of February 2017, along with its 100% exposure to nontraditional activities as LS is dedicated to temporary housing for homeless people.

In addition, LS benefits from a very strong financial profile supported by sector leading financial ratios, such as an EBITDA margin (adjusted for capitalized repairs) of about 77% posted in 2016 (fiscal year ended March 31, 2016). We envision this margin to remain very sound and stable over the next three years (at about 80%) on the back of the increasing revenue base provided by the aforementioned long-term leasing agreements. As part of these agreements, LS also benefits from limited operating expenditures growth, given that the vast majority (around 80%) of repairs and maintenance expenditures is undertaken by LBN as part of its initial agreement, while LS operates strong control over these expenditures for the remaining units.

Under LS' development program, as part of the 10-year extension of its agreement with LBN, LS will provide 800 additional units over the next four years (2017-2020), resulting in higher capital expenditure of about £45 million per year on average in our 2017-2019 base case (in line with our former base-case forecast). As a result of this agreement, these units will be let out to tenants nominated by LBN, while LS will become the landlord of the new properties and will have to bear the cost for repairs and maintenance on these properties. In our opinion, these elements are likely to slightly increase LS' operating expenditures in the medium term, with no impact on its overall financial performance given the very high level of adjusted EBITDA margins displayed.

Meanwhile, we assess LS' debt as low, with an existing debt stock of £172 million as of March 2016, resulting in a debt-to-EBITDA ratio (adjusted for capitalized repairs) of close to 8.7x in 2016, in line with previous years and a driver of LS' very robust profitability. Nonetheless, we envision an increase in debt in coming years, as we expect LS will tap the market to finance its development plan along with refinancing its existing debt expiring in 2020-2025. Therefore, we forecast that the debt-to-EBITDA ratio (adjusted for capitalized repairs) will gradually increase over the next three years to exceed 10x by 2019, along with declining interest coverage of around 2.2x over the next three years compared with 2.8x in 2016. Additionally, we no longer positively factor in our assessment LS' unencumbered assets size as we understand that a large part of these assets are linked to the lease agreements, which prevents LS from selling those assets before the end of those agreements (and if they do so, these assets have to be replaced).

The rating also reflects our opinion of a moderately high likelihood that the U.K. government, working through the Homes and Communities Agency, would provide timely and sufficient extraordinary support in the event of financial distress. In accordance with our rating approach for government-related entities (GREs), our view of a moderately high likelihood of extraordinary government support is based on our assessment of LS' important role for the U.K. government and its public policy mandate. It is also supported by our view of LS' strong link with the U.K.

government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

Liquidity

We view LS' liquidity as strong, reflecting our view that liquidity sources will exceed uses by about 1.5x over the next 12 months underpinned by more than £50 million of undrawn committed facilities, about £17 million of cash flows from operations, and about £12 million of cash and liquid investments. This is a reduction, though, compared to 2.4x in our last rating review. This is mainly due to a projected increase in capital expenditure to more than £45 million as a result of the development program, along with close to £10 million of interest payments.

In our view, LS benefits from satisfactory access to external liquidity. While it has not tapped the capital market so far, LS enjoys access to a diversified pool of banks as illustrated by a secured £75 million revolving credit facility contracted in 2016.

Outlook

The stable outlook reflects our opinion that LS will continue to benefit from revenue growth through long-term leasing agreements, mitigating higher leverage induced by its development plan over the next four years (2017-2020).

We would consider lowering the ratings by one notch if we were to revise downward our assessment of LS' SACP to 'a+'. This would happen if LS had a more aggressive development plan resulting in higher debt far beyond our base-case forecast. This would also lead us to revise downward our assessment of LS' management.

We currently do not see any realistic upside scenario that could lead us to raise the ratings in the next two years, also given our negative outlook on the U.K. (unsolicited AA/Negative/A-1+).

Key Statistics

Local Space Ltd. Financial Statistics

	--Year Ended March 31--				
('000 £)	**2015a**	**2016a**	**2017bc**	**2018bc**	**2019bc**
Number of units	1,802	1,822	1,941	2,130	2,378
Vacancy rates (% of net rental income)	0.4	0.2	0.6	0.6	0.6
Arrears (% of net rental income)*	2.0	1.8	N.A.	N.A.	N.A.
Revenue§	24,777	25,576	26,374	28,841	32,064
Share of revenue from non-traditional activities (%)	100.0	100.0	100.0	100.0	100.0
Operating expense	7,846	8,395	8,389	9,236	10,255
EBITDA†	19,469	19,808	21,053	23,163	25,748
EBITDA/revenue (%)	78.6	77.4	79.8	80.3	80.3

Local Space Ltd. Financial Statistics (cont.)

	--Year Ended March 31--				
('000 £)	**2015a**	**2016a**	**2017bc**	**2018bc**	**2019bc**
Interest expense	6,848	7,136	9,712	10,005	12,758
Debt/EBITDA (x)	8.8	8.7	8.8	9.9	10.6
EBITDA/interest coverage (x)‡	2.8	2.8	2.2	2.3	2.0
Capital expense	7,579	5,627	25,913	53,343	54,916
Debt	172,001	171,640	185,769	228,765	273,565
Housing properties value (according to market value)	N.A.	364,894	N.A.	N.A.	N.A.
Loan to value of properties (%)	N.A.	47	N.A.	N.A.	N.A.
Cash and liquid assets	21,673	18,450	15,000	15,000	15,000

*Current arrears. §Adjusted for grant amortization. †Adjusted for capitalized repairs. ‡Including capitalized interest. a--Actual. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available

Related Criteria And Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Governments - General: Methodology For Rating Public And Nonprofit Social Housing Providers - December 17, 2014
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Local Space Long-Term Rating Lowered To 'AA-' Following Downgrade Of United Kingdom; Outlook Stable - July 4, 2016
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative On Brexit Uncertainties - October 28, 2016

Ratings List

	Rating	
	To	From
Local Space Ltd.		
Issuer Credit Rating		
Foreign and Local Currency	AA-/Stable/--	AA-/Stable/--

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. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Additional Contact, Sovereigns And International Public Finance:
Julien Bernu, London +442071767137; Julien.Bernu@spglobal.com

Additional Contact:
International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com