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Research Update:

U.K.-Based Public Sector Funding Agency MORhomes PLC Assigned 'A-/A-2' Ratings; Outlook Positive

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Overview

- MORhomes, a recently formed U.K. social housing funding agency, has been successful in attracting shareholders and has a broad membership of 62 housing associations.
- MORhomes' start-up status is a rating constraint, but our view for the next few years factors in MORhomes delivering on its mandate and significantly strengthening its operational capacity.
- We are assigning our 'A-' long-term and 'A-2' short-term issuer credit ratings to MORhomes.
- The positive outlook reflects the probability that we could raise the ratings on MORhomes over the next two years if it ramps up its operations and quickly builds a robust record of delivering on its mandate and increasing its market share while posting strong financial ratios.

Rating Action

On Jan. 11, 2019, S&P Global Ratings assigned its 'A-' long-term and 'A-2' short-term issuer credit ratings to U.K. social housing funding agency MORhomes PLC. The outlook is positive.

At the same time, we are assigning our 'A-' issue rating to MORhomes' £5 billion euro medium-term note senior secured debt program.

Outlook

The positive outlook reflects our expectation that, in the next two years, MORhomes will build a significant presence in the capital markets and among its borrowing members. In addition, we expect MORhomes' approved policies and governance standards to ensure conservative risk management that will continue supporting our assessment of a strong financial profile.

Upside scenario

We could raise our ratings over the next two years if MORhomes manages to implement the main pillars of its business plan and increase its presence in the capital markets; significantly increases its lending among its borrowing members to reach a market share of above 20% in the U.K. social housing sector; and maintains its established risk principles. As MORhomes lengthens its track record, its enterprise profile could strengthen and be more comparable with that of peers with higher ratings.

Downside scenario

We could lower our ratings over the next two years should MORhomes' lending performance be weaker than we anticipate, or its financial ratios indicate a weaker position than our current forecast. A weaker public industry country risk assessment (PICRA) resulting from a weaker industry risk assessment of the U.K. social housing sector, or higher sector leverage, particularly in a context of a no-deal Brexit, may put downward pressure on the ratings.

Rationale

In our view, since its inception, MORhomes has been in a good position to achieve its public policy mandate, and over the next two years, it will be able to mitigate the financial risks stemming from its start-up nature.

The ratings on MORhomes reflect our assessment of an adequate enterprise profile and strong financial profile, combined with our uncertainty about MORhomes' effectiveness in carrying out its business plan given its lack of a track record.

The ratings further reflect our assessment of the low industry risk associated with the U.K. social housing sector to which MORhomes will provide lending, in view of the sector's anticyclical nature, high barriers to entry, and strong government oversight.

MORhomes is a public limited company formed in June 2018 to provide borrowing to social housing associations that then join the company as shareholders, a feature we believe is a positive for the enterprise profile, as it likely will foster some loyalty among the associations. The company has not yet produced any financial statements or disbursed any loans, but we assess its financial profile using financial indicators that reflect its approved business plan, policies, and governance standards.

MORhomes operates with a small permanent staff and outsources most functions. Nevertheless, the ultimate decision-making lies with the board members. We believe this structure is reasonable, as MORhomes will engage in a monoline lending strategy focusing on low-risk borrowers typically rated in the single 'A' category. In addition, MORhomes' setup as a pass-through vehicle means that it has very limited exposure to interest rate movements and currency risks. Nevertheless, the structure remains untested and we will monitor developments closely.

Enterprise risk profile: While operating in a low-risk industry, MORhomes' lack of track record executing its strategy limits our view of its credit standing. However, we assess governance standards and management practices as adequate

The U.K. social housing sector has low industry risk. This, combined with strong economic resilience (partly clouded by negotiations for the U.K.'s withdrawal from the EU) and strong financial system risk, results in a low-risk PICRA.

MORhomes' lack of a record in achieving its public policy mandate limits our assessment of its business position. However, in our view, the initial setup where borrowers also sign up as shareholders will support MORhomes in building its presence in the market and becoming relevant to its members.

We view MORhomes' approved management policies and governance standards as adequate, which, combined with its operational structure, will provide a robust platform to ramp up its operations while ensuring strong financial ratios.

In our view, MORhomes' market position will evolve positively in the next two years, as evident from its initial broad shareholder membership of 62 housing associations as of the end of 2018. Nevertheless, our assessment of MORhomes' business position is limited by the company being in a start-up phase.

MORhomes' approved credit policies will likely ensure that concentration on a single borrower is limited, supporting our expectation of revenue stability not being dependent on a few large borrowers. In future, we believe that MORhomes' customer base will be stable, as borrowers are required to join the company as shareholders.

MORhomes has developed its business plan based on its capital structure. The company plans to issue £1 billion each year for the next five years and increase its lending book at the same pace, as it lends the proceeds of all the debt it raises to its borrowers. If it achieves this, we expect that MORhomes will be able to increase its share of the market to about 25% in the next two years.

To reduce operating risk and costs and increase efficiency, MORhomes operates with a small permanent staff and outsources most functions such as credit risk assessment and treasury operations to well-established providers. Nevertheless, the ultimate decision-making lies with the board members, the majority of whom are independent nonexecutive directors with substantial experience in the U.K. social housing sector. In our view, MORhomes' current setup has adequate controls for management to be responsive to stakeholders' interests.

While MORhomes' funding policies mitigate its interest rate, currency, and asset-liability mismatches, the company assesses its credit risk policies effectively and monitors the asset quality of its lending portfolio. We believe that the process currently in place is likely to ensure adequate responsiveness from management to increasing risks in the lending activities, including concentration limits on single and aggregated exposures. In addition, different layers of protection mitigate credit risk, such as a securities pledge on loans and the requirement for additional collateral from borrowers that the company has assessed as having become riskier. We therefore expect any losses from the portfolio to be low and recoveries high.

We consider the U.K. social housing sector as low risk. Our PICRA is favorable because of the sector's low industry risk, combined with a wealthy, open, and diversified economy and adequate leverage risk. This is primarily due to the sector being naturally anticyclical and having strong oversight by the government via regulators. Social housing providers generally experience an increase in demand for their core services in times of economic hardship, and demand typically remains strong throughout the business cycle. Moreover, social housing is usually prominent in political manifestos.

In recent years, English social housing providers' increased exposure to sales activities for subsidizing affordable and social housing development has led us to assess industry risk dynamically. We do this based on providers' individual exposure to the social housing and homebuilding industries. While we do not see a trend of increased exposure to sales activities for the majority of the housing associations, in future, we could revise downward the industry risk assessment that informs our PICRA to reflect such a trend.

Financial risk profile: Operations under a match-funding principle and robust collateralization largely mitigate financial risks

The amount of share capital on which MORhomes is starting its operations provides a robust basis for increasing its lending portfolio. As such, in our view, in the next two years MORhomes will be able to sustain a risk-adjusted capital ratio of at least 7% after adjusting for single-name concentration in its lending portfolio. We include in MORhomes' total adjusted capital 33% of additional equity from subordinated contingent convertible notes.

The convertible notes comply with our requirement to qualify for intermediate equity content. As such, the notes have loss-absorption features to enable MORhomes to operate on a going-concern basis. Furthermore, the notes will have maturities of more than 20 years, longer than those we forecast for the future loans in MORhomes' portfolio.

We take a positive view of the robust collateralization that MORhomes will build on the loan portfolio. Moreover, MORhomes was formed to act as a pass-through vehicle, further neutralizing risks from asset-liability management.

The funding and liquidity ratios are supported by the match-funding policy under which MORhomes is set up to operate and which ensures that the company will not form significant funding or liquidity gaps. We expect the liquidity portfolio to comprise highly rated assets.

We arrive at the overall capital adequacy assessment after incorporating positive adjustments for loss experience, acknowledging that lending is on a secured basis with physical collateral, with very strong prospects for recovery should an association default. We include an additional positive adjustment in our analysis to acknowledge the lack of transformation risk as MORhomes is set up as a pass-through vehicle.

We expect MORhomes to maintain adequate funding and liquidity. We forecast the company's one-year liquidity ratio to be above 1.0x and we do not expect large uncovered needs in the next 12-24 months.

MORhomes will issue its first British pound sterling bonds under a medium-term note program in January 2019, so its market access remains untested. Our funding assessment is neutral, as we do not foresee MORhomes operating with significant funding gaps and the domestic market is deep.

Ratings Score Snapshot

Issuer Credit Rating: A-/Positive/A-2

Issue Rating:
Senior Secured: A-

SACP: a-

Enterprise Risk Profile: Adequate (3)

- PICRA: Low risk (2)
- Business Position: Very Weak
- Management & Governance: Adequate

Financial Risk Profile: Strong (2)

- Capital Adequacy: Very Strong
- Funding and Liquidity: Adequate

Support: 0

- GRE Support: 0
- Group Support: 0

Related Criteria

- Criteria - Governments - International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating; Outlook Action

MORHomes PLC	
Issuer Credit Rating	A-/Positive/A-2

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.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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.