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Ratings

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Research Update:

U.K.-Based Public Sector Funding Agency MORhomes PLC Outlook Revised To Negative From Positive On Prolonged Expansion

December 11, 2019

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Overview

- MORhomes PLC's initial expansion has been slower-than-expected.
- We anticipate that to expand the portfolio to a diversified group of borrowers will, in our view, take at least three years.
- MORhomes' start-up status is a constraint for the rating because fewer-than-expected borrowers will further delay the stabilization of its financial profile due to a slower build-up of capital.
- The likelihood of MORhomes not significantly increasing its loan book in the next two years could result in a lower enterprise profile and put further pressure on the ratings.
- As a result, we are revising our outlook to negative from positive and affirming our 'A-/A-2' ratings on MORhomes.
- The negative outlook reflects the risk of a downgrade in the next two years if MORhomes does not increase meaningfully its loan disbursements to closer to £1 billion per year by 2021.

Rating Action

On Dec. 11, 2019, S&P Global Ratings revised its outlook on U.K. social housing funding agency MORhomes PLC to negative from positive.

At the same time, S&P Global Ratings affirmed its 'A-' long-term issuer credit rating and 'A-2' short-term rating on MORhomes, and its 'A-' issue rating on the company's £5 billion EMTN senior secured debt program.

Outlook

The negative outlook reflects the risk of a downgrade in the next two years if MORhomes does not achieve its targets under its revised business plan, with loan disbursement to closer to £1 billion a year by 2021 and onwards, which would affect its strategic positioning and therefore our view of its enterprise risk profile. In addition, lower-than-expected business expansion, or weakening credit policy would further weaken the overall financial risk profile through lower capital build-up and sustained concentration risks, adding pressure on the rating. 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 also put downward pressure on the ratings.

We could revise the outlook to stable if MORhomes manages to expand its loan book supporting stronger market share and financial ratios, in particular, the capital ratio adjusted for concentration. This would also improve our view of the company's strategic positioning.

Rationale

While the affirmation reflects our expectation for MORhomes to gradually increase its lending activity, the outlook revision also reflects our view that there are rising risks that business expansion could be more prolonged than their revised business plan targets, due to an expanded funding options for social housing entities in the U.K. Therefore, in our view, it would continue operating as a startup-like entity for longer that would continue restraining the rating in the next three years.

We forecast that our capital adequacy assessment would take longer than two years to stabilize at a strong level. However, gradual increases in MORhomes' lending activity would support an overall adequate financial risk profile commensurate with the affirmation when combined with our view of the company's adequate enterprise profile.

MORhomes is a public limited company formed in June 2018 to provide borrowing to social housing associations in the U.K., so the ratings reflect our assessment of the low industry risk associated to this sector. We anticipate the company will navigate the lack of clarity regarding the social housing industry's position in the context of Brexit.

Enterprise risk profile: Despite operations in a low-risk industry, MORhomes' short track record limits our view of its growth outlook

Housing associations in the U.K. join MORhomes as shareholders primarily to get access to lending, a feature we believe is a positive for the enterprise risk, as it likely will foster loyalty. While this is true, pricing and execution in the social housing sector are also imperative and competition is high. This among other operational obstacles has led to meaningfully slower growth than expected. MORhomes has 61 housing association groups as shareholders (adjusted from 62 following two mergers and one new shareholder).

MORhomes operates with a small permanent staff and outsources most functions. Nevertheless, the ultimate decision-making lies with the board members which has experience in the housing and in the banking sector. We believe this structure is reasonable, as MORhomes will engage in a monoline lending operation strategy.

The U.K. social housing sector has low industry risk. This is primarily due to the social housing sector being naturally anti-cyclical 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, housing affordability is usually prominent in political manifestos.

This low industry risk, combined with strong economic resilience (partially clouded by Brexit negotiations) and strong financial system risk, results in our assessment of a low-risk PICRA for MORhomes.

The company's short and delayed record in achieving its stated aim of £1 billion in loans limits our assessment of its business position. While we acknowledge that MORhomes has managed to commence operations and lending activities, there is a material likelihood that business expansion plans would be slower than the revised business plan, and therefore raising questions regarding whether Morhomes is able to effectively achieve its long-term target.

We regard the company's management policies and governance standards as adequate. We believe it will maintain its current risk appetite and not target a significant number of loans to weak borrowers or lower prices significantly to gain business.

MORhomes' approved credit policies will mean that concentration on a single borrower is limited, supporting our expectation of revenue stability not depending on a few large borrowers. We believe that the company's customer base will be stable supported by borrowers joining as shareholders.

In our view, MORhomes' setup has adequate controls for management to respond to stakeholders' interests. While funding policies mitigate the interest rate, currency, and asset-liability mismatches, the company assesses its credit risk policies effectively and monitors the asset quality of its lending portfolio.

Financial risk profile: Operations under a match-funding principle and collateralization largely mitigate financial risks, although portfolio concentration is a rising risk

The amount of share capital on which MORhomes has started its operations provides a platform for increasing its lending portfolio. However, a prolonged expansion of its lending book limits the robustness of its capital adequacy. This is because capital build-up through member contributions will be lower and concentration risks on few borrowers will weigh on capital metrics and take longer to diversify away from.

As a result, in our view, MORhomes' risk-adjusted capital (RAC) after adjusting for single name concentration will likely fluctuate from 3%-5%. As of fiscal year-end 2019 (March 31), the RAC after adjustments was 1%, which largely reflects a still-limited number of borrowers that spur concentration risks. .

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. Therefore, the notes have loss-absorption features to enable the company to operate on a going-concern basis. Furthermore, the notes will have maturities of more than 20 years (larger than the forecasted loans in its portfolio).

We take a positive view of the robust collateralization that MORhomes will build on the loan portfolio although securities charges could happen with a delay. Moreover, the company was formed to act as a pass-through vehicle, further neutralizing risks from asset-liability management and limiting its exposure to interest rates movements and currency risks.

The funding and liquidity ratios are supported by the match-funding policy under which MORhomes is set up to operate and ensure that the company will not form significant funding or liquidity gaps. Therefore, we expect the company to maintain adequate funding and liquidity. We forecast its one-year liquidity ratio to be above 1.0x and we do not expect large uncovered needs in the next 12-24 months.

Our funding assessment is neutral, because we do not foresee MORhomes operating with significant funding gaps and the domestic market is deep.

Ratings Score Snapshot

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

Issue Ratings:

- Senior Secured: A-

SACP: a-

Enterprise Risk Profile: Adequate (3)

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

Financial Risk Profile: Adequate (3)

- Capital Adequacy: Adequate
- 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

Ratings Affirmed; Outlook Action

	To	From
MORHomes PLC		
Issuer Credit Rating	A-/Negative/A-2	A-/Positive/A-2
Ratings Affirmed		
MORHomes PLC		
Senior Secured	A-	