FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Together to 'BB-/Negative'; HoldCo Debt to 'B'

Thu 18 Jun, 2020 - 17:12 ET

Fitch Ratings - London - 18 Jun 2020: Fitch Ratings has downgraded Together Financial Services Limited's (Together) Long-Term Issuer Default Rating (IDR) to 'BB-' from 'BB' and removed it from Rating Watch Negative (RWN). The Outlook on Together's Long-Term IDR is Negative.

Senior (PIK) toggle notes issued by Together's indirect holding company Bracken Midco1 PLC (Midco1) have been downgraded to 'B'/'RR6' from 'B+'/'RR6' and removed from RWN. A full list of rating actions is below.

The downgrade of Together largely reflects Fitch's view that the economic impact from the coronavirus pandemic and related mortgage payment holiday will put pressure on asset quality, liquidity and ultimately revenue and earnings stability. Redemption and repayment cash flows will, in our view, be materially lower in 2020 and heightened IFRS9 impairment charges will also put pressure on profitability although Fitch's base case assumes that Together will remain profitable in 2020.

We also view that a prolonged pause of new originations may start to affect Together's historically sound franchise in specialised mortgage lending and reflect negatively on the overall business model, although our base case assumes Together will resume lending activities in 2H20.

Our base case assumptions are informed by Fitch's worsening Global Economic Outlook, which forecasts a steep 7.8% GDP contraction in the UK alongside a sharp increase in the unemployment rate for 2020 followed by a gradual recovery starting in 2021.

The Negative Outlook on the Long-Term IDR reflects Fitch's view that Together remain sensitive to a further economic deterioration and notably a slower-than-expected recovery. While Together's liquidity position has improved since the onset of the pandemic and we expect further improvements as redemption levels recover following the end of the lockdown, it remains sensitive to asset-quality developments in a more adverse economic scenario, notably increasing arrears and housing market inactivity.

In April 2020, Together paid interest due on Midco1's PIK toggle notes in-kind with the intention of preserving liquidity at the operating entity during the initial and uncertain stage of the crisis. If Together were to continue paying interest on the PIK toggle notes in-kind rather than cash (which is not Fitch's expectation) then this could indicate pressure on its consolidated corporate liquidity and lead to a downgrade of its Long-Term IDR as well as Finco's and Midco1's debt ratings.

KEY RATING DRIVERS

IDRS AND SENIOR DEBT

The IDR of Together is underpinned by its long-established franchise in providing secured credit to under-served borrowers, a tested business model encompassing robust underwriting, generally healthy profitability and an increasingly diversified, albeit largely secured, funding profile. This mitigates the inherent risk involved in lending to a niche sector of non-standard UK borrowers and the associated funding and leverage needs.

Loans are secured on UK property with loan to value (LTV) ratios maintained below 60% and underwriting performed on an individualised basis. Together's non-performing loan (NPL) ratio is higher than that of mainstream lenders (9.3% at end-March 2020) as its customers are largely non-standard borrowers. While the mortgage payment holidays instigated by the UK government should not automatically add to Stage 3 loans under IFRS 9, we expect the NPL ratio to increase, albeit on a lagged basis, alongside the forecast deteriorating economic climate. However, actual principal losses have historically been low as a result of the robust security value backing each loan.

Together's profitability metrics have traditionally been strong, reflecting a higher-yielding mortgage book (compared with prime mortgage lenders) but lending margins have moderated somewhat in recent years due largely to higher-rate loans originated during the credit crisis being replaced with lower rate offerings as well as some product mix effect and increased competition compressing nominal rates. In our base case, we assume Together's profitability in 2020 to be materially lower.

Together's leverage metrics have increased with gross debt-to-tangible equity increasing to 5.1x at end-March 2020 from 4.5x at end-June 2019. This is largely attributable to the increased funding requirements of Together's increased loan origination and, absent any net losses, we expect Together's leverage to improve marginally in 2020 because the group has largely stopped new loan originations.

When calculating Together's leverage, Fitch adds Midco1's debt to that on Together's own balance sheet, regarding it as effectively a contingent obligation of Together. Midco1 has no separate financial resources of its own with which to service it, and failure to do so would have considerable negative implications for Together's own creditworthiness. Profits are largely re-invested in the business and this somewhat mitigates the dependence on debt funding.

Together has diversified its funding profile in recent years but funding sources are largely wholesale, public and private securitisations and listed senior secured notes. The covenanted nature of these facilities and the high level of balance-sheet encumbrance reduce liquidity flexibility.

Together's liquidity benefits from no significant near-term debt maturities and adequate headroom within current facilities for new originations. However, redemptions and repayments are materially down on prior levels and housing market inactivity and increasing arrears could put pressure on liquidity sources. Nonetheless, Fitch believes Together's liquidity has stabilised and immediate availability is adequate, although remaining sensitive to a sharp reduction in loan redemptions.

MIDCO1 -SENIOR PIK TOGGLE NOTES

Midco1's PIK toggle notes have been downgraded in line with that of Together's IDR, from which their rating is notched. As Midco1's debt is taken into account when assessing Together's leverage, and Midco1 is totally reliant on Together to service its obligations, Together's IDR is the appropriate anchor for Midco1's debt. The notching of Together's IDR and the rating of the senior PIK toggle notes reflects Fitch's view of the likely recoveries in the event of Midco1 defaulting. While sensitive to a number of assumptions, this default scenario would only be likely to occur when Together is also in a much weakened financial condition, as otherwise its upstreaming of dividends for Midco1 debt service would be maintained.

RATING SENSITIVITIES

IDRS AND SENIOR DEBT

As reflected in the Negative Outlook, Together's IDR and debt ratings are primarily sensitive to further adverse changes in the macro economic outlook which could cause a weakening of Together's asset quality or liquidity position.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Liquidity pressures, which could arise from a significant decline in redemptions and repayments and/or material depletion of Together's immediately accessible liquidity buffer, for example if Together needs to swap eligible assets into the securitisation vehicles to cure covenant breaches, then this could weaken its corporate liquidity. In addition, paying the interest on Midco1's PIK toggle notes in-kind in October 2020 could be viewed as an indication of ongoing pressures on corporate liquidity.

-Evidence that Together's franchise has become negatively impacted by the decision to curtail new lending.

-A material slowdown in Together's rate of internal capital generation, for example due to a deteriorating operating environment adversely affecting asset quality and leading to higher NPL metrics, could lead to a downgrade. This would be particularly relevant if accompanied by growth in the loan book leading to rising leverage.

- Consolidated leverage materially increasing above 5x on a sustained basis, which could arise if further debt is drawn, tangible equity reduced and significant losses absorbed.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-The Outlook on Together's Long-Term IDR and debt ratings could be revised to Stable if the group's liquidity position remains resilient in the current operating environment assuming other financial metrics remain broadly unchanged (or improve).

-Contained increases in arrears and unchanged franchise strength following the decision to largely curtail lending while being able to maintain adequate earnings and leverage would also support an Outlook revision to Stable.

-In the medium-term, an upgrade would require more stable economic conditions supported by an improved assessment of Together's franchise and business model, in addition to improving financial-profile metrics, notably asset quality and earnings and profitability.

MIDCO1 - SENIOR PIK TOGGLE NOTES

The rating of the senior PIK toggle notes is sensitive to changes in Together's IDR, listed above, from which it is notched, as well as to Fitch's assumptions regarding recoveries in a default. Lower asset encumbrance by senior secured creditors could lead to higher recovery assumptions and therefore narrower notching from Together's IDR. The notes would be sensitive to wider notching if they are further structurally subordinated by the introduction of more senior notes at Midco1 with similar recovery assumptions.

External appeals

In accordance with Fitch's policies the issuer appealed and provided additional information to Fitch that resulted in a rating action which is different than the original rating committee outcome.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING				RECOVE
Jerrold Finco Plc					
• senior secured	LT	BB-		Downgrade	
Together Financial Services Limited	LT IDR	BB-	Rating Outlook Negative	Downgrade	
	ST IDR	B		Affirmed	
Bracken Midco1 Plc					
• subordinated	LT	B		Downgrade	RR6

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Non-Bank Financial Institutions Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bracken Midco1 Plc	EU Issued
Jerrold Finco Plc	EU Issued
Together Financial Services Limited	EU Issued

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Non-Bank Financial Institutions   Europe   United Kingdom
