Research Update:
U.K. Social Landlord Swan Housing Association Assigned 'AA-' Rating; Outlook Stable

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Table Of Contents
- Overview
- Rating Action
- Rationale
- Outlook
- Related Criteria And Research
- Ratings List
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Overview

• Swan Housing Association is a U.K.-registered provider of social housing operating in Essex and East London.
• We assess Swan's enterprise profile as very strong and its financial profile as strong.
• Swan benefits from what we view as a moderately high likelihood of receiving extraordinary support from the U.K. government.
• We are assigning our 'AA-' long-term issuer credit rating to Swan.
• The stable outlook reflects our forecast of improving adjusted EBITDA margins to about 35% revenues. We also assume that the refinancing goes ahead as planned, and believe that the group will continue to embed its new governance framework and controls.

Rating Action

On Feb. 18, 2015, Standard & Poor's Ratings Services assigned its 'AA-' long-term credit rating to U.K. social housing provider Swan Housing Association Ltd. (Swan). The outlook is stable.

Rationale

The 'AA-' rating on Swan is based on its stand-alone credit profile (SACP), which we assess at 'a+'. It is also based on our opinion of a moderately high likelihood that the U.K. government (AAA/Stable/A-1+), working through the Homes and Communities Agency (HCA), would provide timely and sufficient extraordinary support in the event of financial distress.

Under our criteria for government-related entities (GREs), our view of a moderately high likelihood of extraordinary government support is based on our assessment of Swan's important role for the U.K. government and its public policy mandate, and its strong link with the government. The government's track record of providing strong credit support in certain circumstances reflects this link.

Swan's very strong enterprise profile is a rating strength. We note the very strong economic fundamentals in Swan's area of operations in East London and Essex; its experienced management team and consistent strategy; and its good operational performance with low voids and arrears. We see the social housing industry as low risk, globally.
The rating also factors in Swan's strong financial profile. The group's debt position and financial performance are supported by forecast improving profitability, and Swan also exhibits very strong liquidity over the next 12 months. In addition, we view its financial policies as transparent and prudent.

In the past two years, Swan has overhauled its governance and its controls after grant was claimed with false documentation in a period leading up to late 2011. The HCA subsequently downgraded Swan to its lowest governance rating of G3, while Swan embarked on a governance review—particularly of its development finance controls. Since then, the HCA has raised its governance rating on Swan, and we note that Swan received significant development grant and stock transfers from local authorities in the period since 2011.

In our opinion, the fact that Swan continued to receive grant partly reflects Swan's key role as a deliverer of large-scale renewal projects such as the 700-home Bow Cross estate in East London. Projects of this size have been part of Swan's strategy since the housing association was founded in Basildon New Town about 20 years ago. Swan's expertise and consistency in this area is a rating strength.

We assess Swan's operational performance as strong, despite it having taken on stock transfers and other large estates. Voids have been low at 2.6% of net rent receivable on average over the past three years and current arrears are about 3.0%, which constitutes a very good performance for a social landlord operating in London. Three-quarters of Swan's development program is focused in London, and we believe its focus on East London and Essex means there is considerable demand for its homes. About 40% of the group's properties are in London at the moment, and we estimate that, across its entire stock, social rents are about 52% of market rents (based on HCA and Valuation Office Agency data) and population growth is forecast to be about 1% to 2022. That said, in 2013/14 we note that Swan generated about 50% of its revenues from activities that we consider to be less stable than general needs social housing, such as supported housing and development for sale.

Owing to its location, Swan benefits from high demand for properties developed for sale on the open market. This carries risks, particularly around house price volatility in London. Swan manages this by obtaining the right to discontinue a development after each stage, thereby breaking down concentration risk and price risk into smaller phases (around 200 units per phase in the case of Blackwall Reach in Tower Hamlets). The group can also swap tenure types from outright sale to a product with more stable revenues—such as shared ownership or market rent—during a house price crash. Nonetheless, the cyclical nature of large project revenues is causing uneven adjusted EBITDA: although it remains robust at 34% of revenues on average in the five years to 2016/17, it was 30% of revenues on average in the three years to 2013/14. In all, we view Swan's financial performance as weaker owing to the extra risk related to 30% of the group's revenues that come from property sales.
That said, we believe that Swan's large development pipeline will support strong and improving profitability over the 2015-2018 forecast period. We forecast adjusted EBITDA margins rising to more than 35% of revenues, from a low of 28% in the financial year ended March 31, 2014. This underpins our view of the group's strong financial performance and supports our opinion of the affordability of its debt. Swan's debt profile is robust, in our view, with adjusted EBITDA interest coverage of 1.7x and debt at 14.2x adjusted EBITDA on average over the five years to 2016/17. Both these metrics will look stronger as profits rise—our base case forecast is for 10.6x and 2.0x, respectively, in 2016/17—although we expect debt levels to remain more or less stable.

This is despite the refinancing of its current syndicated bank facilities that Swan plans to undertake by issuing a bond at the end of the current financial year, ending in March 2015. After fees and settling the mark-to-market position on the embedded floating-fixed interest rate swaps, the refinancing's effect on the debt burden will be more or less neutral. That said, the bond will lower the group's exposure to interest rates, increasing its proportion of fixed-rate debt to about 70%, from 55% currently. For this reason, we do not factor in the current interest rate exposure as a material risk in our assessment of the debt position.

Liquidity

We assess Swan as having a strong liquidity position. We forecast that, if the bond goes ahead as planned, the group's existing sources of liquidity exceed its currently expected uses by about 1.4x over the 12 months to Jan. 31, 2016. If the bond issuance does not proceed, we forecast that sources will cover uses by 1.6x over the same period, because we assume the group would not rearrange its current undrawn committed facilities in the meantime (and would not face transaction costs related to the refinancing). Our base case forecast assumes that the bond is issued as planned, but the issuance will not affect our assessment of Swan's overall liquidity position.

Outlook

The stable outlook reflects our forecast of improving adjusted EBITDA margins to about 35% of revenues or higher. This is predicated on revenues from London-focused development activity improving, particularly from market sales. It also assumes that the refinancing goes ahead as planned and that the group continues to embed its new governance framework and controls.

We could raise the rating if Swan's financial performance improves substantially, thereby also improving the group's debt position, with debt of less than 10x adjusted EBITDA on average or adjusted EBITDA interest coverage of more than 2.5x on average. Such a scenario would also include improving liquidity and we would view management's strategy and financial policies as having developed a strong track record after the recent process of renewal.
We could lower the rating if, for example, Swan's operating performance declines with voids or arrears worsening to more than 6% of net rent receivable. In this scenario, Swan also refocuses its development strategy on areas elsewhere in Essex, where there is lower demand for social housing than in London.

Related Criteria And Research

Related Criteria
• Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014
• Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Related Research
• U.K. Social Housing Risk Indicators, Oct. 27, 2014

Ratings List

New Rating

Swan Housing Association Ltd
Issuer Credit Rating AA-/Stable/--

Additional Contact:
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