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Research Update:

U.K.-Based Social Landlord Swan Housing Association Ltd. 'AA-' Rating Affirmed; Outlook Stable

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Overview

- Swan Housing Association (Swan) has a very strong enterprise profile and a strong financial profile, in our view. Swan also benefits from a moderately high likelihood of receiving extraordinary support from the U.K. government.
- We are therefore affirming our 'AA-' long-term credit rating on Swan.
- The stable outlook reflects our view of Swan's expansion into London as a supportive factor of its economic fundamentals, and our expectation that financial performance and debt will be relatively stable over the next two years.

Rating Action

On Feb. 16, 2016, Standard & Poor's Ratings Services affirmed its 'AA-' long-term credit rating on U.K. social housing provider Swan Housing Association Ltd. (Swan). The outlook remains stable.

Rationale

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

In accordance with our criteria for government-related entities (GREs), our view of the 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 U.K. government, demonstrated by the government's track record of providing strong credit support in certain circumstances.

Swan's SACP is supported by its very strong enterprise profile. Its portfolio of about 11,000 units is located in London and Essex, areas that exhibit stronger operating environments than the rest of the U.K. Other credit strengths include consistent strategy and management's successful implementation of the renewed governance framework. Swan's superior asset quality is supported by its relatively modern stock (average age of 25 years), low arrears, and low vacancy rates. The company also benefits from very low expenditure on maintenance. We continue to assess the social housing sector as low risk, globally.

The group follows a strategy of generating a sizable portion of its revenues from development for outright sale. In 2015, total nontraditional activities accounted for 43% of revenues. Although we view this strategy as consistent with Swan's operational capabilities, we regard these activities as riskier than traditional social housing. Swan mitigates this risk by linking the delivery of open market sales to regeneration projects, which have an important role and receive support from the local councils.

Swan has come a long way since the discovery of false documentation used to claim a grant in late 2011. The group diligently complied with the investigation when the HCA lowered its governance score to G3, one of the lowest levels. The governance score has since been raised twice, and in early 2015 the HCA was convinced that the renewed governance framework is fully functional and fulfils the requirements for the top score. It therefore awarded Swan a G1 governance score.

Our rating also reflects Swan's strong financial profile. The group's debt position and financial performance are expected to remain stable in the tough operating environment prevailing in the sector. That said, we believe the group has proactively taken measures to mitigate the impact from welfare reforms.

We believe that the welfare reforms announced in 2015 by the U.K. government--particularly the government directive to cut social rents by 1% until 2019/2020--will have implications for the whole sector. Swan generates a large proportion of its revenues from nontraditional activities, such as open market sales. This reduces the effect of the announced changes on the group relative to other, more-traditional housing associations. That said, we still expect the loss of rental income due to rent cuts to slightly exceed £6 million per year by 2019/2020 and £180 million over the life of the 30-year business plan. To mitigate the impact on overall surplus from lost revenue, the management has taken measures to identify pockets of efficiencies within the operating cost structure and development spending. As per current plans, efficiency savings of £1.1 million per year have been identified and delivered. This is in addition to the £10 million of savings expected over the next four years. We understand from our discussion with management that these savings are largely attributable to a change in procurement strategy and savings in development design costs.

We expect Swan's financial performance to be robust in the current financial year 2015/2016, with adjusted EBITDA margins reaching 40% of total revenues. This would be an increase of about 4% from last year and will bring the five-year average EBITDA to about 35% by 2018. Our forecast of financial performance factors in changes in the sector and Swan-specific elements. We anticipate that financial performance will remain stable or improve marginally to about 36% of revenues. Development for open market sales (including first tranche sales of shared ownership) formed about 24% of revenues in 2014/2015 and is expected to exceed 40% over our two-year forecast horizon, as the group continues to expand in East London. Regeneration remains a key element of the strategy, as Swan has completed its Bow Cross development and has now started work on the next phase of the Blackwall Reach and Craylands developments. Swan manages development risk, to some extent, by close association with the local authorities at each development stage.

In early 2015, Swan absorbed a large one-off cost owing to the restructuring of its borrowing portfolio. The restructure of the funding facility involved moving from a four-member syndicate to bilateral relationships with three banks. The total cost associated with this restructure amounted £25 million. The covenants have now been fixed at £55,000 of net debt per unit, and 1.1x of interest cover over the life of the bank loans. We note that Swan is comfortably in compliance with these covenants.

To facilitate this restructuring, Swan raised £250 million via the capital market, although £100 million of this bond has been retained. The issuance was priced at 3.625% against Swan's assumption of 4.5%--thus providing further savings over the business plan. Of the bond proceeds, £120 million were used to refinance the existing borrowing; therefore we observe an increase of £30 million in total debt. The five-year average debt to Standard & Poor's-adjusted EBITDA ratio reached 14.5x. Debt/EBITDA fluctuates as EBITDA varies, but in our base-case scenario, we assume that this metric will remain below 15x. Following the fixed-rate issuance, 67% of Swan's borrowing is at fixed rates.

Liquidity

Over the next 12 months, we forecast that sources will exceed uses of liquidity by 1.46x, which we consider as strong. This is also in line with our forecast last year. The ratio is supported by the £41 million committed undrawn bank facilities available from banks, £40 million of which are revolving credit facilities.

We assess Swan's external liquidity as satisfactory.

Outlook

The stable outlook reflects our view of Swan's expansion into London as a supportive factor of its economic fundamentals, and our expectation that its financial performance and debt will be relatively stable over the next two years.

We could lower the rating on Swan if the group's overall operating performance declines, with voids or arrears worsening to more than 6% of net rent receivable. We could also lower the rating if the risk from outright sales increases, such that this damages our assessment of the group's enterprise profile and our view of the group's internal risk management processes.

We could raise the rating on Swan if we were to observe a marked improvement in the financial performance, such that average adjusted EBITDA margins exceed 40% of revenues; and this also translates into an overall improvement in the group's debt position. This will likely be supported by improving economic fundamentals, as the group continues to expand in Greater London.

We could also raise or lower the rating if we changed our view of the likelihood of extraordinary government support, which would follow our reassessment of the housing association's policy role for and link with the U.K. government. We view any such changes as unlikely.

Key Statistics

Swan Housing Capital PLC Financial Statistics

	--Year Ended 31-March--						
(Mil. £)	**2012**	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**
Number of units owned or managed	10,979	11,018	11,124	11,125	11,374	11,393	11,632
Voids/net rental income (%)	3.0	2.4	2.3	2.1	N.A.	N.A.	N.A.
Current arrears(%)	3.0	2.8	2.2	2.6	N.A.	N.A.	N.A.
Financial Performance							
Reported EBITDA/revenues (%)	31.0	36.0	31.7	40.2	45.1	42.8	38.8
Adjusted EBITDA (after capitalized repairs)/revenues (%)	28.1	32.9	27.9	35.6	40.4	38.0	34.9
Development for sale/revenues (%)	39.3	33.8	32.3	24.2	30.0	27.3	42.1
Debt Profile							
Debt/adjusted EBITDA (x)	16.1	14.1	18.2	17.0	12.4	13.6	11.5
Adjusted EBITDA/interest payable and capitalized interest (x)	1.7	1.9	1.4	0.7	2.0	1.7	1.8
Financial Statistics							
Income Statement (Mil. £)							
Turnover	106.3	104.8	89.5	82.0	96.2	94.0	120.1
Operating costs	(80.3)	(74.5)	(68.5)	(57.1)	(62.0)	(62.9)	(82.7)
Of which depreciation	(6.9)	(7.4)	(7.4)	(8.0)	(9.2)	(9.1)	(9.2)
Operating surplus/(deficit)	26.0	30.3	21.1	24.9	34.2	31.1	37.4
Interest income	0.1	0.3	0.1	0.1	0.1	0.6	0.7
Interest payable	(13.2)	(15.9)	(15.7)	(40.5)	(18.0)	(20.1)	(22.6)
Net surplus (deficit) before tax	13.1	15.1	6.2	(15.1)	16.5	11.8	15.7
Cash Flow (Mil. £)							
Net cashflow from operations	13.2	36.9	44.0	24.7	32.9	18.7	37.1
Net interest	(12.9)	(15.4)	(15.9)	(36.9)	(19.3)	(20.4)	(22.3)
Net investing activities	(24.3)	(12.1)	(20.8)	(31.1)	(2.3)	(18.5)	(10.4)
Cash in/(out) before financing	(24.1)	9.4	7.3	(43.4)	11.3	(20.2)	4.4
Net cash flow from financing	38.7	5.2	(29.9)	43.1	(12.8)	4.8	(4.4)
Increase/(decrease in cash)	14.6	14.6	(22.6)	(0.3)	(1.5)	(15.4)	(0.0)
Balance Sheet (Mil. £)							
Housing properties (according to balance-sheet valuation)	644.4	646.9	651.9	754.3	1072.1	1088.2	1099.7
Debt	481.5	485.9	455.2	494.9	483.8	485.7	481.3
Cash and short-term investments	28.3	42.8	20.4	20.1	18.6	3.2	3.2

bc--Base case reflects Standard & Poor's expectation of the most likely scenario, which may differ from the entity's own forecasts. 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: Group Rating Methodology - November 19, 2013

Related Research

- U.K. Social Housing Risk Indicators, Nov. 10, 2015
- Tenants' Right To Buy Will Bring Mixed Fortunes For English Housing Associations, Sept. 9, 2015
- Credit FAQ: Examining The Credit Implications Of Recent Government Reforms On U.K. Housing Associations, Sept. 9, 2015

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.

Ratings List

	Rating	
	To	From
Swan Housing Association Ltd.		
Issuer Credit Rating	AA-/Stable/--	AA-/Stable/--
Swan Housing Capital PLC		
Senior Secured		
Local Currency[1]	AA-	AA-

[1] Dependent Participant(s): Deutsche Bank AG (London Branch), Swan Housing Association Ltd.

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