S&P Global
Ratings

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Research Update:

Swan Housing Association Downgraded To 'BBB' On High Sales Exposure And Leverage

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Overview

- We anticipate that the financial metrics for Swan Housing Association (Swan) will worsen throughout our forecast period to the fiscal year ending March 2023 (FY2023) due to the fallout of the COVID-19 pandemic.
- While we note the recently updated strategic plan indicates a shift of the development program, we expect exposure to open market sales, including joint ventures (JVs), to remain close to 50% until FY2023.
- We are therefore lowering our rating on Swan to 'BBB' from 'BBB+'.
- The stable outlook balances the risks of further deterioration in Swan's finance risk profile with the possibility of a quicker shift away from the riskier sales program than we currently anticipate.

Rating Action

On Nov. 16, 2020, S&P Global Ratings lowered its long-term issuer credit rating on U.K.-based Swan Housing Association to 'BBB' from ' BBB+'. The outlook is stable.

At the same time, we lowered to 'BBB' from 'BBB+' the issue rating on the £250 million bond issued by Swan Housing Capital PLC. This entity was set up for the sole purpose of issuing bonds and lending the proceeds to Swan, and we view it as a core subsidiary of the Swan group.

Rationale

One or more of the credit ratings referenced within this article was assigned by deviating from S&P Global Ratings' published criteria. We think that significant exposure to sales activities limits the visibility and predictability of future earnings in a way not typically seen with a traditional housing association that mainly provides social rent properties. In our view, exposure to sales activities will also reduce the association's ability to withstand external risks. We therefore deviate from our "Criteria - Governments - General: Methodology For Rating Public And Nonprofit Social Housing

Providers," published on Dec. 17, 2014, when assessing the industry risk for housing associations that generate more than one-third of their revenues from market sales. We do this by blending S&P Global Ratings' industry risk assessment for social housing providers (2), and that for homebuilders and real estate developers (4) in line with "Criteria - Corporates - Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry," published on Feb. 3, 2014. For more information see "Credit FAQ: How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers," published on Aug. 6, 2018.

The downgrade reflects our expectation that low margins on open market sales, combined with the elevated debt levels, will constrain Swan's financial position. Weak sales execution, delayed building signoffs, and the COVID-19-related lockdown have hampered Swan's ability to execute its ambitious development plan. The company's debt service coverage and liquidity also weakened as the COVID-19 pandemic led to construction delays and an increasing stock of unsold units. Nevertheless, Swan continues to generate healthy margins in its more traditional business of social and affordable rent, of at least 45%, which we expect to continue over the three-year forecast period.

As for other English housing associations, we believe there is a moderately high likelihood that Swan would receive extraordinary support in case of financial distress. This provides a two-notch uplift from the stand-alone credit profile (SACP). Swan's primary purpose is to provide affordable homes, supporting important policy objectives of the U.K. government. We consider that the Regulator of Social Housing (RSH), a government agency, regulates Swan to promote a viable, efficient, and well-governed social housing sector, and maintain lender confidence and low funding costs across the sector. It is therefore our view that the RSH would step in to prevent a default in the sector, based on its record of being willing and able to provide extraordinary support on a timely basis.

During FY2020, Swan delivered nearly 500 market sale (private and shared ownership) units but less than 300 were sold. As such, Swan remains below its current sales targets. Furthermore, the crane accident at the Watts Grove construction site in summer 2020 paused the completion as well as the corresponding rental income on the shared ownership units expected in FY2021 and FY2022. We now expect income from these units to be delayed to FY2023. Swan did not complete any new homes between March 2020 and July 2020 and we forecast that the average sales price of private sales in FY2021 will fall below £400,000 from £544,000 in FY2020 as more units from Essex are made available for sale. In our opinion, Swan's forecasting and reporting is less frequent and robust than peers who have increased their frequency and depth in reporting in recent years. Its track record in managing risks associated with sales informs our view that management and financial policies are weaker than average.

In response to feedback received from the RSH, which lowered Swan's governance score to G2 from G1 in January 2020, Swan split the deputy chief executive/group finance position into two posts to further strengthen the team in April 2020 and hired a new executive director of treasury in June 2020.

We anticipate that Swan's relatively small portfolio and its exposure to the residential housing market in London and the South East of England gives it less flexibility to absorb any operational shock than its peers. That said, we note that in response to COVID-19, the board approved policies in April 2020 to reduce work in progress to less than 25% of housing assets from 30%. It also paused new development schemes or sub phases of development schemes while the number of unsold properties remains elevated. Therefore, we think that the economic fundamentals upon which Swan generates its revenues are still supportive but have deteriorated since our last review. Solid demand for its traditional business, combined with forecast annual population growth of 0.4%, also support Swan's low vacancy rates, which dropped to 1.7% from 2.0% in FY2020. We note that the general needs stock remains below 1%, although NHS keyworker accommodation has 8.6% voids, which is better than peers but pushes up the overall voids level.

With an average portfolio age of around 23 years, Swan's current asset portfolio is one of the newest in S&P Global Ratings' rated portfolio and requires less ongoing maintenance than peers', putting Swan in a better position than peers with portfolios nearly twice that age. We continue to view Swan's operational performance as strong, supported by low general needs tenant arrears of around 2% in FY2020. Swan is addressing lower satisfaction rates brought about by social distancing measures in response to the outbreak of COVID-19 through technology investments to create an interactive customer service portal that it launched earlier this year. With the conversion to universal credit well underway, self-payers now account for 40% of tenant revenue and current arrears have grown to 2.6% in August but still below its London peers.

While FY2020 marked record group turnover of £170 million, this significantly underperformed Swan's budget of £287 million as open market sales fell 35% short due to construction delays and building safety signoffs. Fire safety requirements--a health and safety issue prevalent to many U.K. housing associations--to replace cladding containing Aluminium Composite Material at two older schemes have begun this year. The majority of the cost is covered by grants, reducing Swan's net liability to £3.4 million.

Under our updated COVID-19 base-case scenario for 2021, we assume continued delays in sales to extend into fiscal 2022 and that Swan will suffer losses in rent collections from tenants who do not receive housing benefits due to the economic damage caused by the COVID-19 pandemic. Based on these assumptions, we forecast debt to EBITDA will average 19x over the next three years, higher than the 15x we previously forecast. This change is driven by higher market sales income, averaging around £80 million, but average margins of only 7% over the next three years, resulting in S&P Global Ratings-adjusted EBITDA margins of around 18% of revenue, weaker than the 31% observed in FY2019 and 19% in FY2020. However, this pressure is balanced by very strong margins from Swan's social rent and shared ownership units, with three-year forecasted averages of 47% and 52%, respectively.

We anticipate Swan's interest coverage ratios, which have historically remained around 2x, to stabilize around 1.3x over the FY2021-FY2023 forecast period. In our opinion, this exposes the Swan group to pressure in terms of debt service coverage if its financial operations were to deviate from our base-case assumptions.

We consider Swan's debt profile to be vulnerable, with debt to EBITDA just below 20x. We also apply a negative adjustment to Swan's debt profile as our calculation of leverage is above 70%, and any further sales delays will require drawing down available liquidity and possibly issuing additional debt. We note that the debt profile is currently 83% fixed and 17% variable, with hedging instruments on two loans with maturities until 2038. Given the low interest rate environment, these instruments report a large negative fair value adjustment that we remove from our debt analysis, as Swan does not have to post collateral and maintains the optionality to terminate, which it does not intend.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety

Liquidity

Over the next 12 months, we estimate Swan will continue to maintain strong liquidity and cover debt service. However, we project £243 million sources of cash to cover £154 million of uses by about 1.58x, below our previous forecast of 2.07x.

Sources include:

- Current cash of around £18 million.
- Cash flow from operations (including working capital adjustments) of £126 million.
- Undrawn contractually committed facilities expiring beyond 12 months of £81 million.
- Other receipts from restricted accounts, VAT recoveries, and JV income of £18 million.

Uses include:

- Capital expenditure and working capital adjustments of about £116 million.
- Debt service (including interest costs) of about £38 million.

We view Swan's access to external liquidity as satisfactory, given its ready access to bank funding, but we consider its track record of issuance in the capital markets to be limited. Swan successfully accessed the market, selling £25 million of its retained bond at a 4% coupon in March 2020 which generated £4 million in premium. This helped support its liquidity position and pay down the £29 million loan to the Greater London Authority for the development of Cambridge Road by calendar year-end.

Outlook

The stable outlook reflects our view that the strong operating performance and high asset quality of Swan's underlying social housing portfolio will help loosen the volatility and liquidity constraints caused by elevated open market sales exposure.

Downside scenario

We could lower the rating on Swan over the next 24 months if the group's sales continue to be delayed and we notice further deterioration in its financial metrics. For instance, a correction of the housing market, more severe lockdown restrictions, and longer delays to market sales than our current assumption would materially erode Swan's financial performance and liquidity, and the group may need to issue more debt.

Upside scenario

We could raise the rating on Swan if it permanently shifts its strategy toward derisking--including reducing its exposure to open market sales--and focuses on traditional activities and improving financial metrics. A positive rating action would also depend on Swan moderating its debt burden and strengthening its liquidity position.

Key Statistics

Table 1

Swan Housing Association Ltd. Key Statistics

	--Year ended March 31--				
(Mil. £)	2019a	2020a	2021bc	2022bc	2023bc
Number of units owned or managed	11,330	11,646	11,771	11,933	12,124
Revenue§	80.6	169.9	163.3	185.3	156.1
Share of revenue from sales activities (%)	10.8	48.5	48.9	55.3	36.8
EBITDA§†	25.3	31.7	30.7	30.6	31.3
EBITDA/revenue §†(%)	31.4	18.7	18.8	16.5	20.1
Capital expense†	29.0	56.7	115.7	116.8	96.3
Debt	558.4	612.6	580.4	577.6	574.5
Debt/EBITDA §†(x)	22.1	19.3	18.9	18.8	18.4
Interest expense*	21.2	22.9	23.8	23.2	23.1
EBITDA/interest coverage§†* (x)	1.2	1.4	1.3	1.3	1.4
Cash and liquid assets	29.4	95.8	40.1	33.3	16.4

§Adjusted for grant amortization. †Adjusted for capitalized repairs. *Including capitalized interest. a--Actual. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N.A.--Not available.

Ratings Score Snapshot

Table 2

Swan Housing Association Ltd. Ratings Score Snapshot

Industry Risk	4
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Financial policies	4
Financial profile	5

S&P Global Ratings bases its ratings on non-profit social housing providers on the eight main rating factors listed in the table above. S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published on Dec. 17, 2014, summarizes how the eight factors are combined to derive each social housing provider's stand-alone credit profile and issuer credit rating. For social housing providers generating more than a third of its consolidated revenues from open market sales, we also refer to the "Key Credit Factors For The Homebuilder And Real Estate Developer Industry."

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 23, 2020
- ESG Industry Report Card: Public And Nonprofit Social Housing Providers Outside The U.S., Aug. 4, 2020
- Global Social Housing Ratings Risk Indicators: July 2020, July 14, 2020
- Global Social Housing Ratings Score Snapshot: July 2020, July 14, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Outlook 2020: Social Housing Providers Face Pressure From Rising Demand and Maintenance Backlog, Nov. 25, 2019
- Credit FAQ: How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers, on Aug. 6, 2018

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Swan Housing Association Ltd		
Issuer Credit Rating	BBB/Stable/--	BBB+/Negative/--
Swan Housing Capital PLC		
Senior Secured	BBB	BBB+

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.