Research Update:

Swan Housing Association Affirmed At 'BBB'; Outlook Stable

May 13, 2021

Overview

- Swan Housing Association's debt metrics have weakened through our forecast period to the fiscal year ending March 2024 (FY2024) with its debt to adjusted EBITDA estimated at above 20x.
- This is counterbalanced by the stronger operational performance of its underlying assets as demonstrated by a lower vacancy rate.
- We have therefore affirmed our 'BBB' rating on Swan.
- The stable outlook reflects our view that Swan will gradually reduce its sales exposure thereby containing any further deterioration of its financial metrics.

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Rating Action

On May 13, 2021, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on U.K.-based Swan Housing Association. The outlook is stable.

At the same time, we affirmed our 'BBB' 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 rating on Swan reflects our view that its expected deterioration of debt metrics in FY2021 will be offset by some operational improvement, including a notable reduction in the proportion of vacant rental properties and unsold homes. In last few months of FY2021, Swan reduced its number of unsold units, having sold all but one home from its completed schemes. The group's development plan remains focused on multiple regeneration schemes resulting in lower and more volatile margins as well as weaker debt metrics than peers.

Swan is a small-to-mid-sized entity with just under 12,000 units focused within its core markets of London and Essex. We consider that the population growth across these operating areas is close to 0.4%, which is in-line with the national average of 0.5%, and that the group's social and affordable rent levels are about 57% of market rents. These factors support the demand prospects for Swan's rental housing.

We assess Swan's industry risk as in-line with that for homebuilders and real estate developers. Generally, we apply this assessment when we project an entity would generate more than half of its total operating revenues from outright sales (including land sales and sales income from joint ventures, but excluding first-tranche shared ownership sales), or we think that all market sales activities (including first-tranche sales of shared ownership units) would exceed two thirds of total operating revenues. We forecast revenues from outright sales activities (including from Swan's share of joint ventures [JVs]) exceeded half of the group's overall revenue in FY2023. As Swan's exposure to JV sales increases over the development plan, our outright sales levels will remain elevated.

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. 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.

We consider the operational performance of Swan's underlying properties has improved, demonstrated by the continued reduction in its vacancy rates. With an average portfolio age of around 24 years, compared with nearly 50 years for S&P Global Ratings' rated portfolio, Swan's current asset portfolio is one of the youngest. We believe its rental stock therefore typically requires less ongoing maintenance than peers'. We note that the current vacancy level has fallen below 1%, which has improved our three-year average to below 2%. This drives the improvement in asset quality and our view on Swan's enterprise risk.

While Swan has significant exposure to fire safety risks, with several towers currently under costly waking watch, we acknowledge that the costs of cladding repairs at two sites have mostly been covered by grants received in FY2021. We expect fire safety related building work to cost around £1 million each year over our forecast period.

Our adequate assessment of management reflects Swan's higher risk appetite for concurrent multiple regeneration projects and a developing risk management framework. We note that progress has been made toward improving the risk management framework, with more detailed board reporting and stress testing scenarios. We understand that the financial policies are expected to be updated later this year to incorporate more robust liquidity analysis and modelling of cash flows between Swan and its JVs. Swan's work on calculating the cost to achieve decarbonization is also just developing as its five-year stock condition survey commences in June.

During FY2021, delays in development and corresponding sales caused by the COVID-19 pandemic reduced Swan's revenue from sales, while at the same time shrinking the related capital expenditure. We therefore expect the pandemic to have had an overall neutral impact on financial performance in FY2021. While the level of sales income still averages around £80 million throughout the forecast period, more activity has been pushed into FY2023 compared with the last base case. Sales margins for both first tranche and outright sales remain weak, estimated at under 10% over the next three years. This is somewhat offset by very strong margins from Swan's social rent and shared ownership rental income units, resulting in S&P Global Ratings-adjusted five-year average EBITDA margins of around 18% of revenue, weaker than the 21% five-year average at last review. With respect to the rental properties, we assume Swan will receive consumer price index (CPI)+1% throughout the forecast period. Gross arrears reached close to 3.5% in August 2020 but have since stabilized at around 3% by the end of FY2021, which compares well with Swan's London peers at over 6%. In FY2022, we assume that Swan will suffer some rent losses due to rent arrears, particularly from tenants not in receipt of government benefits.

Our forecast of Swan's debt metrics has weakened on the back of Swan's lower EBITDA. Specifically, we anticipate its debt to adjusted EBITDA will average 21x over the next three years, higher than the 19x three-year average we had previously expected. We note the risk that further sales delays could require additional borrowing.

We estimate that Swan's leverage--as calculated as debt outstanding to current value of property (book value)--is above 70%, which could limit its borrowing capacity. We also consider that Swan on-lends to JVs and any delays in debt repayment would require the group to maintain higher levels of debt. We note that the debt profile has increased its exposure to variable rate debt and is currently 73% fixed and 27% 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.

We anticipate Swan's interest coverage ratios will stabilize at around 1.2x over the FY2022-FY2024 forecast period, which is weaker than its London-based peers. In our opinion, this exposes Swan to risks associated with debt service coverage if its financial performance were to weaken from our base-case assumptions. We also expect non-sales EBITDA will not fully cover the group's interest costs in FY2022 but will achieve full coverage from FY2023 thanks to the supportive rental settlement of the CPI+1% increase.

Liquidity

Over the next 12 months, we estimate Swan will continue to maintain strong liquidity and cover debt service. We project £190 million sources of cash to cover £127 million of uses by about 1.49x.

Sources include:

- Current cash of around £47 million.
- Cash flow from operations (including working capital adjustments) of £97 million.
- Undrawn contractually committed facilities expiring beyond 12 months of £40 million.

- Other receipts from restricted accounts and VAT recoveries of £7 million.

Uses include:

- Capital expenditure of about £97 million.
- Debt service interest costs of about £25 million.
- Debt service principal repayment of £4 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.

Outlook

The stable outlook reflects our view that Swan will gradually reduce its sales exposure thereby containing a further decline of its financial metrics.

Downside scenario

We could lower the rating if the group's sales continue to be delayed and we notice further deterioration in its financial metrics, especially liquidity. For instance, delayed repayments of on-lent JV borrowings, disruptions to development, and longer delays to market sales than our current assumptions would materially erode Swan's financial performance and liquidity, and the group may need to issue more debt. We could lower the rating on Swan if we revised downward our assessment of likelihood of extraordinary support. Specifically, our view of the importance of Swan's role to the government could change should it persistently generate most of its income from commercial activities, such as open market sales.

Upside scenario

We could raise the rating if Swan's financial metrics improve structurally. This includes it reducing its debt burden to below 20x of EBIDTA, achieving materially stronger financial performance, and improving its liquidity position.

Key Statistics

Table 1

Swan Housing Association Ltd. Key Statistics

	--Year ended March 31--				
(Mil. £)	**2020a**	**2021e**	**2022bc**	**2023bc**	**2024bc**
Number of units owned or managed	11,646	11,784	11,896	12,032	12,183
Revenue§	169.9	179.7	132.8	184.9	152.0
Share of revenue from sales activities (%)	58.3	59.6	45.5	58.5	47.7
EBITDA§†	31.7	29.4	23.4	29.4	29.8
EBITDA/revenue §†(%)	18.7	16.4	17.6	15.9	19.6
Capital expense†	56.7	94.7	96.3	126.9	69.5

Table 1

Swan Housing Association Ltd. Key Statistics (cont.)

	--Year ended March 31--				
(Mil. £)	2020a	2021e	2022bc	2023bc	2024bc
Debt	612.6	588.0	601.8	618.5	610.8
Debt/EBITDA §†(x)	19.3	20.0	25.7	21.0	20.5
Interest expense*	22.9	23.8	23.5	23.8	23.5
EBITDA/interest coverage§†* (x)	1.4	1.2	1.0	1.2	1.3
Cash and liquid assets	95.8	46.0	25.0	25.0	25.0

§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.

Ratings Score Snapshot

Table 2

Swan Housing Association Ltd. Ratings Score Snapshot

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Enterprise profile	3
Financial performance	6
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Financial policies	4
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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, April 23, 2021
- Building Up Debt: U.K. Social Housing Sector Braces Itself For Borrowing, March 16, 2021
- Global Social Housing Ratings Score Snapshot: December 2020, Dec. 10, 2020
- Global Social Housing Ratings Risk Indicators: December 2020, Dec. 10, 2020
- Outlook 2021: Strong Liquidity Should Help Social Housing Providers Remain Resilient, Dec. 8, 2020
- U.K. Social Housing Providers Should Remain Largely Resilient To Short-Term Economic Difficulties From COVID-19, April 23, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- U.K. Social Housing Ratings History: February 2020, March 3, 2020
- Why Most Rated U.K. Social Housing Providers Are At Home In The 'A' Category, Dec. 3, 2019
- Credit FAQ: How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers, on Aug. 6, 2018

Ratings List

Ratings Affirmed	
Swan Housing Association Ltd	
Issuer Credit Rating	BBB/Stable/--
Swan Housing Capital PLC	
Senior Secured	BBB