S&P Global
Ratings

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Research Update:

Swan Housing Association Downgraded To 'BBB+' On Volatile Financial Performance, High Leverage; Outlook Negative

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Overview

- We believe the reliance of U.K.-based Swan Housing Association (Swan) on sales activities brings substantial volatility to the business and constrains its creditworthiness.
- Under our updated base-case projections, we forecast that Swan's financial performance and liquidity will weaken and Swan will maintain high leverage through the financial year to March 2022.
- We are therefore lowering our long-term rating on Swan to 'BBB+' from 'A-'.
- The negative outlook reflects our view that delays to open market sales reinforce volatility and put pressure on Swan's adjusted credit metrics.

Rating Action

On Dec. 17, 2019, S&P Global Ratings lowered the long-term issuer credit rating on U.K.-based Swan Housing Association to 'BBB+' from 'A-' based on volatile financial performance and a weakening debt profile.

At the same time, we also lowered to 'BBB+' from 'A-' the rating on the £250 million bond issued by Swan Housing Capital PLC. Swan Housing Capital 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 'BBB+' rating includes two notches of uplift from the stand-alone credit profile of 'bbb-', supported by our view that there is a moderately high likelihood the U.K. government would provide extraordinary support to Swan, through the Regulator of Social Housing, in the event of financial distress. Our view 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.

The negative outlook reflects our view that Swan's corporate strategy of deriving in excess of 50% of its revenue base from commercial activities over the next few years increases its financial risk. We consider that Swan's debt service coverage and liquidity could be significantly hampered if delayed open market sales continue to persist, especially if the U.K. housing markets experiences a severe correction. We also anticipate that the relatively small size of Swan's portfolio and its exposure to the residential housing market in London and the southeast of England gives it less flexibility to absorb any operational shock than its peers. That said, we acknowledge that management has changed policies to bring open market sales down to 40% from 60% and reduce open sales exposure through more joint venture (JV) development going forward. Currently, around 60% of Swan's housing portfolio is in Essex and the remaining 40% is in London. Therefore, we think the economic fundamentals upon which Swan generates its revenues are still supportive. Robust demand, combined with forecast annual population growth of 0.7%, also support Swan's low vacancy rates, which remained stable at 2.2% in FY2019.

Swan experienced its third consecutive year of declining revenue, posting revenues of £81 million in financial year (FY) 2019. We have revised our assessment of Swan's financial performance to highly vulnerable from vulnerable due to the significant volatility in operating performance. Based on Swan's current development plan, we forecast that revenues from market sales alone will average around £85 million over the next three years, resulting in S&P Global Ratings-adjusted EBITDA margins around 23% of revenue, weaker than the 31% observed in FY2019.

The costs associated with market sales are traditionally higher than those associated with lettings activity, and this weighs on profitability. In our view, consumer confidence, disposable income, employment levels, and growth, as well as interest rates and the availability of mortgage loans, ultimately drive demand for the properties for sale, and that this heightens revenue and earnings volatility. Additionally, high variability in sales levels and property valuations, as manifested by recent fluctuations in U.K. housing prices, render social housing groups vulnerable to business cycle blips.

During fiscal 2019, Swan's development schemes experienced delays due to fire safety approvals at two projects which resulted in total revenue of only £81 million compared to our previous base case of £146 million. This is mitigated by the continued growth and strong margins in its core business of social housing lettings. Under our updated base-case scenario for 2020, we expect continued delays in sales to extend into early fiscal 2021 and that full handover at Blackwall Reach will occur within the first three months of calendar year 2020. Under these assumptions, we forecast debt to EBITDA, which stood at 24.5x at FY2019, will settle around 15x over the next three years, higher than the 13x we previously forecast. We have revised our assessment of Swan's debt profile downward to adequate from strong as our calculation of leverage places our gearing above 70%, and any further delays will require drawing down available liquidity and possibly issuing additional debt.

That said, Swan has reported steady progress and good reservation figures across all projects, and recently received approval for two JV projects in Essex. We consider the management to be adequately experienced at pre-selling its units and managing the risks from its sales program. Swan's management team also produces stress tests, monitors sector prospects every six months, and has mitigation plans. Since its development schemes have several phases, management can choose to pause construction if a market downturn occurs.

We anticipate Swan's interest coverage ratios, which have historically remained around 2x, to stabilize around 1.7x over the FY2020-FY2022 forecast period. In our opinion, this exposes Swan's group to downward pressure in terms of debt service coverage if its financial operations were to deviate from our base-case assumptions.

Swan's management is anticipating some pressures in the East London market, and has decided to gradually reduce risk and position its portfolio toward South Essex and the outskirts of London, where it is seeing more value. We view this as a positive development, although we do not expect the product mix to change materially over the next two-to-three years. Swan's core activities will remain focused on regeneration schemes, with a balance of high-rise and medium-rise constructions. Swan is in the process of completing a Type 4 fire risk assessment across all properties above 18m in height within its portfolio. Swan is currently working with contractors on two properties with ACM and has set aside a £10 million residual, which they believe is more than sufficient to cover upgrade costs not already in progress or covered by grants. We consider that the recent strategic partnership concluded with the Greater London Authority (GLA) also commits Swan to maintaining a substantial part of its development program in the capital.

With an average portfolio age around 22 years, Swan's current asset portfolio is new compared to peers. We view Swan's operational performance as strong, supported by low general needs tenants arrears, which at just stood around 2% in FY2019.

Liquidity

Over the next 12 months, we estimate Swan will maintain very strong liquidity, although it will decline as additional grant funding has not been as high as in past years. We project sources of cash to cover uses by about 2.1x.

Sources include:

- Current cash of around £15 million.
- Cash flow from operations of £44 million.
- Expected cash from sale of current assets of about £2.5 million.
- Undrawn contractually committed facilities expiring beyond 12 months of £81 million.
- Cash injection of £3 million, largely stemming from additional funding recently contracted with the GLA.

Uses include:

- Capital expenditure (capex) of about £32 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.

Outlook

The negative outlook indicates that we could lower our ratings on Swan and its debt over the next 24 months if Swan's development for sales activities underperform our base case or were to further weaken its debt service coverage and liquidity.

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 deterioration of debt service coverage ratios, especially EBITDA interest coverage from social housing activities only, at the end of fiscal 2020. Should a correction of the housing market occur and market sales are frozen, Swan's financial performance and liquidity would erode materially.

Upside scenario

We could revise the outlook to stable over the next 24 months if we observe a sustainable improvement in financial performance in line with 'A-' rated peers, we see a reduced appetite for market-related developments, and at the same time we view the level of support from the U.K. government as unchanged, all else being equal.

Table 1

Swan Housing Association Ltd. Selected Financial Indicators

	--Year ended March 31--				
(Mil. £)	2018a	2019a	2020e	2021bc	2022bc
Number of units owned or managed	10,718	11,486	11,851	12,251	12,397
Revenue§	90.6	80.6	164.5	217.5	147.6
Share of revenue from sales activities (%)	25	11	56	65	47
EBITDA§†	27.5	25.2	35.9	45.1	38.5
EBITDA/revenue§† (%)	30.4	31.3	21.8	20.8	26.1
Capital expense†	42.3	33.8	10.9	38.9	23.7
Debt	508.6	619.3	582.7	586.7	560.1
Debt/EBITDA§† (x)	18.5	24.5	16.2	13.0	14.6
Interest expense*	18.8	21.2	24.0	23.4	23.1
EBITDA/interest coverage§†* (x)	1.5	1.2	1.5	1.9	1.7
Cash and liquid assets	13.7	29.4	10.8	1.6	3.1

§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

Industry risk	4
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Strategy and management	4
Asset quality and operational performance	2
Enterprise profile	4
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Financial profile	4

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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Outlook 2020: Social Housing Providers Face Pressure From Rising Demand and Maintenance Backlog, Nov. 25, 2019
- Global Social Housing Ratings Score Snapshot: December 2019, Dec. 2, 2019
- Global Social Housing Risk Indicators: December 2019, Dec. 2, 2019
- 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

Downgraded

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