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## Research Update:

# Swan Housing Association Rating Lowered To 'A-' On Earnings Volatility; Outlook Stable

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## Research Update:

# Swan Housing Association Rating Lowered To 'A-' On Earnings Volatility; Outlook Stable

(**Editor's Note:** In the previously published version of this research update, the stand-alone credit profile was omitted. We have updated this version to include it.)

## Overview

- Swan Housing Association's (Swan) significant increase in market sales from 2019--which we consider riskier than traditional social housing activity--results in more volatile and therefore lower quality earnings.
- As a result, we are lowering the issuer credit rating on Swan to 'A-' from 'A'.
- At the same time, we note that high quality social housing assets in areas of robust demand should somewhat mitigate the downside risk from sales.
- The stable outlook reflects our view that Swan will retain its strong economic fundamentals, supported primarily by high demand for housing in its areas of operation, and reduce non-traditional exposure beyond the current peak in sales.

## Rating Action

On Feb. 13, 2018, S&P Global Ratings lowered its long-term issuer credit rating on U.K.-based social housing provider Swan Housing Association to 'A-' from 'A'. The outlook is stable.

At the same time, we lowered the rating on the £250 million bond issued by Swan Housing Capital PLC to 'A-'.

## Rationale

The downgrade reflects Swan's embarkation on a sizeable development-for-sales program, leading to earnings volatility that we anticipate will exceed 20% over our five-year base case to financial year (FY) end 2020. As a response to government grant cuts and continued pressure to deliver more homes, Swan has increased its exposure to market sales with the aim to cross-subsidize development of social housing. In our view, the high proportion of built-to-sell (nearly 60% of revenues will come from outright sales by FY2020), and Swan's relatively small size, expose it to the risk of a potential correction in the residential real estate market.

Swan's social housing assets enjoy robust demand with nearly 60% of its stock

in Essex and the rest in London--both dynamic areas with very strong economic fundamentals. We expect the demand in this region will continue to remain strong amid steady population growth of around 0.9%, resulting in low vacancy rates for Swan's properties. That said, vacancy rates on Swan's key worker units generally tend to be around 8%-12%. This results in overall vacancy rates slightly exceeding 2% in FY2017. Although Swan's region of operation has particularly high house prices, the demand for new homes is still relatively buoyant. We positively note the quality of Swan's relatively modern housing stock, with low arrears, in our ratings assessment. We anticipate Swan will incur limited financial costs related to corrective fire safety measures on two of its developments.

In our view, development-for-sale revenues will peak beyond 60% of total revenues in FY2019 and FY2020--the highest proportion among rated peers. We expect the steady-state proportion of revenues from such activities to fall beyond FY2020 but to remain elevated relative to peers. In the upcoming sales peak, we anticipate delivery of 890 homes by FY2020--of which more than 80% are likely to be sold on the market (including outright sales and shared ownership units). These activities are cyclical in nature as they depend on factors such as employment levels and growth, disposable income, and consumers' expectations. In contrast, traditional social housing benefits from strong government support and oversight that limits volatility and cyclicity risk. Therefore, high exposure to sales weakens Swan's economic fundamentals and results in lumpy earnings, which we see as high risk when volatility exceeds 20% over our five-year base case.

As a result of the higher exposure to sales, we expect financial performance to weaken over the coming years, thereby constraining the rating. We expect Swan's revenues to nearly double in the next two years as peak sales revenues are received; however, it will not see a corresponding increase in underlying EBITDA--therefore putting pressure on the margins to drop below 30% by FY2020. Underlying social housing EBITDA is expected to remain stable over our five-year base case to FY2020 and, importantly, we note that Swan can comfortably cover interest payments from this source of earnings.

Nevertheless, we see management as effective in managing the risks from the large sales program, particularly given its focus on selling off-plan. We take into account the depth of stress-testing of risks and Swan's mitigation strategy. In our view, the focus on pre-selling reduces the associated risks and results in upfront cash inflows. For example, Swan has sold nearly 30% of the "for sale" to be completed over the next three years, including the entire 65-unit Oldchurch development sold to one party prior to completion. We note that regeneration development is carried out in small phases, about 150-200 units at a time, to mitigate the concentration risk of sales. Regeneration of underdeveloped areas generally receives local authority support--Swan received land for the Blackwall Reach development from the borough of Tower Hamlets at no charge upfront; Tower Hamlets will retain a proportion of the profits as the development is sold in the future. This, in our view, aligns the council's interests with the successful delivery of the project.

Our base-case forecast is for Swan's leverage to remain moderately high at around 13x debt to EBITDA, underpinned by sales receipts from two large developments--Blackwall Reach and Cambridge Road--in the next two years. Delays in sales receipts could result in debt to EBITDA rising sharply to exceed 16x over the same period. We believe the risk from high loan-to-value of about 70% is somewhat offset by Swan's still-large unencumbered asset base, which is about 50% of outstanding debt. We continue to see Swan's financial policies as prudent, particularly its liquidity policy and overall disclosure levels. At the same time, high debt levels and the expansion of market-related activities mitigate these strengths.

S&P Global Ratings views Swan as a government-related entity with strong links with the U.K. government, via the Regulation Committee of Homes England. We also view Swan, and the sector in general, as having an important public policy role, and we have therefore assessed Swan's role as important to the government.

Our view of Swan's important public policy role partly factors in the potential effect that a cash default may have on the appetite of private lenders to continue to lend to the whole sector at rates lower than for comparable corporate entities. It also partly reflects the political repercussions of an enforcement and sale of security, which could lead to an asset no longer being used for social housing. This combination of the strong link and important role leads us to believe that the likelihood of extraordinary support to Swan, if required, is moderately high, resulting in a one-notch uplift to the 'bbb+' stand-alone credit profile.

## **Liquidity**

Over the next 12 months, we estimate Swan will maintain a healthy liquidity position with sources of cash of about £249 million covering uses of about £167 million by about 1.5x.

Sources include:

- Current cash of around £11.99 million.
- Cash flow from operations of £20.7 million.
- Expected cash from sale of current assets of about £48.4 million proceeds from market sales.
- Undrawn contractually committed facilities expiring beyond 12 months of £161.7 million.
- Cash injection from a government grant of £6.4 million.

Uses include:

- Capital expenditure (capex) on repairs and new development of about £5.45 million.
- Debt service (including interest costs) of about £24.2 million.
- Working capital outflows of £137.4 million that refers to costs from market-related activities (not reflected in capex).

## Outlook

The stable outlook on Swan reflects our view that it will maintain strong economic fundamentals, supported primarily by high demand for housing in its areas of operation. Furthermore, we believe its management will reduce non-traditional exposure beyond the current peak in sales.

We could lower the rating on Swan if the group further increased exposure to built-for-sale, with a greater focus on outright sales. In this scenario, we would see the strategic plan as more aggressive, therefore affecting our view of the fundamental strength of the enterprise. We could also lower the rating if we revised down our view of the likelihood of extraordinary support from the U.K. government.

We could raise the rating if Swan materially reduced its exposure to sales, such that we do not anticipate the earnings volatility to persist, and at the same time if we observe financial performance improving sustainably above 30% over our base case.

**Table 1**

Swan Housing Association Ltd. Selected Financial Indicators					
Balance Sheet Date Year	year end March 31				
	2016a	2017a	2018bc	2019bc	2020bc
£ mil.					
Number of units owned or managed	8,880	8,823	8,842	9,141	9,191
Vacancy rates (% of rent net of identifiable service charge)	2.4	2.2	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	2.7	2.5	N.A.	N.A.	N.A.
Revenue§	109.6	101.1	97.8	174.1	194.8
Share of revenue from non-traditional activities (%)	48.6%	42.4%	40.8%	66.1%	69.8%
EBITDA¶	35.8	32.7	33.4	46.5	49.9
EBITDA/revenue (%)	32.7	32.3	34.2	26.7	25.6
Interest expense	16.5	17.7	22.4	23.8	24.3
Debt/EBITDA (x)	13.3	14.7	15.6	11.3	10.6
EBITDA/Interest coverage† (x)	2.2	1.8	1.5	2.0	2.1
Operating costs	(28.3)	(46.3)	(50.4)	(68.2)	(64.5)
Capital expense	12.4	12.2	42.9	28.5	22.8
Debt	474.7	481.8	520.1	526.8	531.3
Housing properties (according to balance sheet valuation)	706.1	694.5	736.0	762.8	783.9
Loan to value of properties (%)	67.2	69.4	70.7	69.1	67.8
Cash and liquid assets	14.9	37.3	39.8	32.8	34.2

\*Rent and service charge arrears. §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

**Table 2**

Swan Housing Association Ltd. Ratings Score Snapshot	
Industry risk	2
Economic fundamentals and market dependencies	3
Strategy and management	3
Asset quality and operational performance	2
Enterprise profile	3
Financial performance	5
Debt profile	3
Liquidity	3
Financial policies	3
Financial profile	4

S&P Global Ratings' analysis of social housing providers' creditworthiness rests on our scoring of eight key rating factors: (i) industry risk; (ii) economic fundamentals and market dependencies; (iii) strategy and management; (iv) asset quality; (v) financial performance; (vi) debt profile; (vii) liquidity; and (viii) financial policies. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published Dec. 17, 2014, and "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015, detail how we derive and combine the scores, and then determine each social housing provider's stand-alone credit profile and the issuer credit rating. In accordance with S&P Global Ratings' public and nonprofit social housing providers methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating, the committee can make use of the flexibility afforded by paragraphs 12-17 of "Methodology For Rating Public And Nonprofit Social Housing Providers."

## 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, Dec. 17, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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

- Global Social Housing Risk Indicators: January 2018, Jan. 30, 2018
- Social Housing Rating Score Snapshot: January 2018, Jan. 30, 2018
- New Rent Policy Bring Relief, But No Big Boost To The Credit Standing Of U.K. Housing Associations, Jan. 31, 2018
- U.K. Social Housing Scenario Analysis: What Could Happen To Ratings In A Market Downturn?, Sept. 25, 2017
- Credit FAQ: Brexit Uncertainties Mean Higher Credit Risk And Lower Ratings For The U.K. Social Housing Sector - October 31, 2016

## Ratings List

Downgraded; Outlook Action

To

From

*Research Update: Swan Housing Association Rating Lowered To 'A-' On Earnings Volatility; Outlook Stable*

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

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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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://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.

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