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Research Update:

Swan Housing Association Downgraded To 'A' On Increased Sales Risk; Outlook Negative On Weakening Margins

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Overview

- Swan Housing Association's (Swan's) increased market sales, which we consider riskier than traditional social housing activities, result in more volatile and consequently lower quality earnings.
- Swan's relatively smaller size compared with peers and its significant exposure to private market sales make it more vulnerable to the risks that a lengthy Brexit process would pose for London's housing market.
- We are lowering our long-term issuer credit rating on Swan to 'A' from 'A+'.
- The negative outlook reflects the possibility that we could lower the rating further if we observed structural deterioration in Swan's financial risk profile.

Rating Action

On Oct. 31, 2016, 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 negative.

At the same time, we lowered our long-term issue rating on Swan's £250 million senior secured bond due 2048 to 'A' from 'A+'.

Rationale

The rating action incorporates our view that Swan is turning increasingly to non-traditional activities, including development of properties for sale on the open market, as a way to mitigate recent regulatory changes, such as cuts in social rents and lower grants from the central government. These changes will likely put pressure on Swan's revenue stream.

We think the development and homebuilding activity carries higher risk than Swan's sub-market rental income stream and affects our assessment of management's risk tolerance. These activities are typically characterized by cyclicality risk, owing to their links to consumer confidence, disposable income, employment levels and growth, household formation, and other demographic factors. Property supply (including availability of vacant properties), the availability of mortgage loans, and government programs intended to support the housing sector also affect this segment of the housing industry. This potentially more volatile stream of income reduces, in our view, the quality of earnings for a housing association.

Indeed, Swan's current development program involves regenerating sites with a majority of private tenures. This entails significant investments to be realized, with returns expected over a two to three-year horizon. Swan has a pipeline of about 1,500 homes to be delivered over the next three to four years, of which about 900 units have been committed. A large proportion of the homes under development--about 65%--are for sale on the open market. Equally, a sizable chunk will be completed in 2019--just over 55%. Therefore, we expect Swan will generate more than 60% of its revenues from commercial sales in 2019. We also consider first-tranche sales of shared ownership as a non-traditional source of income in that it carries an element of sales risk. That said, we believe shared ownership to be lower risk than outright sales. Swan plans to sell a further 20% of units under construction via shared ownership. We note that developing for sale requires Swan to compete with private developers on pricing, primarily driven by land acquisition prices. Therefore, operating margins on sale of units on the private market are typically lower than for traditional social housing activity.

The 'A' rating on Swan is one notch higher than our assessment of its stand-alone credit profile (SACP) at 'a-'. The SACP reflects Swan's strong enterprise risk profile, supported by high demand for housing in its area of operations--mainly in London and the South East. In our assessment of Swan's strong asset quality, we factor in its relatively modern stock and historically low arrears. The management demonstrates prudence and a focus on risk mitigation strategy.

We acknowledge that Swan possesses significant mitigating plans in case of a market downturn, such as pausing or rescheduling development schemes, converting tenures from private sales to social rent, and a concerted effort on pre-selling. In addition, regeneration development generally comes with local authority support and is carried out in small phases, of about 150-200 units at a time, to mitigate concentration risk of sales. For instance, Swan received land for Blackwall Reach development from the borough of Tower Hamlets at no charge upfront. Tower Hamlets will retain a portion of the profits as the development is sold in the future. This, in our view, aligns with the borough's interest in successful delivery of the projects.

Although our base-case forecasts indicate downward pressure on Swan's financial performance, with its adjusted EBITDA margins weakening to about 25% in 2019, and relatively high leverage, these are somewhat mitigated by prudent financial policies and consistently strong internal liquidity. Swan's strong financial profile is also linked to the level and valuation of residential sales--particularly to the timely and on-budget delivery of its regeneration projects, in our view.

In our view, Swan's size and relative exposure to development for sale activity compared with peers makes it more vulnerable to the risks that a lengthy Brexit process would pose for London's housing market, even though we acknowledge that the low-to-mid valuation housing market where Swan operates is not likely to be the first affected. We also base our assessment on the moderately high likelihood that Swan would receive extraordinary support, if needed, from the U.K. government, working through the Homes and Communities Agency.

In accordance with our criteria for government-related entities, including Swan, we base our view of the likelihood of extraordinary government support on our assessment of the association's important role for the U.K. government and its public-policy mandate, and its strong link with the U.K. government. The U.K. government has a track record of providing extraordinary support to the sector in case of distress.

Liquidity

In our view, Swan has strong internally generated liquidity. Sources of cash over the next 12 months of about £170 million will sufficiently cover uses of about £105 million by 1.6x, based on our estimates. Sources of cash include contractually committed facilities of about £120 million. Of these facilities, £50 million relates to undrawn credit facilities, £40 million to retained bonds that can be monetized, and about £30 million to funding available from project finance loans.

Uses of cash include £80 million of capital expenditures related to the construction of units to be sold on the open market, and capitalized repairs. We estimate debt service to be about £20 million over the next 12 months. At the same time, we believe Swan would have satisfactory access to external sources of liquidity, if needed.

Outlook

The negative outlook reflects the risk to Swan's financial profile stemming from its larger exposure to open market sales and concentration of risk within its development program.

We could lower the rating on Swan over the next 24 months if its financial risk profile weakened, such that S&P Global Ratings-adjusted EBITDA declined structurally below 30% of revenues, on average, or if Swan's internal liquidity materially weakened.

We could revise the outlook on Swan to stable over the next 24 months, if we observed sustainable improvement in financial performance, reduced appetite to develop for sale on the open market, and, at the same time, if economic conditions in the U.K. stablized following negotiations to leave the EU.

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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Notting Hill Housing Downgraded To 'A+' On Weakening Financial Profile; Outlook Negative On Heightened Sales Risk - Oct. 4, 2016
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative On Brexit Uncertainties - Oct. 28, 2016
- U.K. Public Finance Recap: The Impact Of Brexit - July 6, 2016
- Swan Housing Association Ltd. Long-Term Rating Lowered To 'A+' Following U.K. Downgrade; Outlook Negative - July 04, 2016

Ratings List

	Rating	
	To	From
Swan Housing Association Ltd		
Issuer Credit Rating		
Foreign and Local Currency	A/Negative/--	A+/Negative/--
Swan Housing Capital PLC		
Senior Secured		
Local Currency[1]	A	A+

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

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. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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.

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