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Research Update:

Swan Housing Association Long-Term Rating Affirmed At 'A'; Outlook Remains Negative

Primary Credit Analyst:
Ratul Sood, CFA, London +44 (0) 20 7176 6536; ratul.sood@spglobal.com

Secondary Credit Analyst:
Jean-Baptiste Legrand, London (44) 20-7176-3609; jb.legrand@spglobal.com

Table Of Contents

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Overview

- Swan Housing Association's (Swan) continued increase in market sales--which we consider riskier than traditional social housing activities--results in more volatile and thus lower quality of earnings.
- Furthermore, we anticipate EBITDA margin compression due to lower margin non-traditional activities.
- At the same time, Swan continues to benefit from a moderately high likelihood of government support, which yields a one-notch uplift to the stand-alone credit profile (SACP), assessed at 'a-'.
- Therefore, we are affirming our long-term issuer credit rating on Swan at 'A'.
- The negative outlook reflects the risks arising from non-traditional activities that weigh on Swan's financial position, particularly its EBITDA margins and liquidity position.

Rating Action

On Feb. 15, 2017, S&P Global Ratings affirmed its long-term issuer credit rating on U.K.-based social housing provider Swan Housing Association (Swan) at 'A'. The outlook is negative.

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

Rationale

The 'A' rating on Swan reflects our assessment of its SACP of 'a-' and our view that there is a moderately high likelihood of Swan receiving extraordinary support from the U.K. government. In our view, Swan's size and relative exposure to develop-for-sale activity, compared with peers, make it more vulnerable to the risks that a lengthy Brexit process could 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 believe a large proportion of development activity focused toward market sales carries a higher risk than a sub-market rental income stream and affects our assessment of management's risk tolerance. These activities are typically characterized by higher cyclicality risk due to their relationship with consumer confidence, disposable income, employment levels, and growth, as well as other demographic factors. This potentially more volatile stream of income reduces, in our view, the quality of earnings for a housing association.

That said, we view the traditional social housing sector as low risk globally. There tends to be strong demand for social housing services throughout economic cycles. Moreover, governments globally tend to support social housing through revenue or supply-side subsidies, and empower regulatory authorities to provide control and support on an ongoing basis, thereby reducing industry risk.

Swan enjoys above average demand for its services, given the attractive location of its stock--37% of its stock is based in London and the remaining 63% in the South East. Furthermore, it maintains strong economic fundamentals despite its revenue exposure toward non-traditional activities (such as open market sale and shared ownership first tranche sales).

Indeed, Swan's current development program involves regenerating sites with a majority of private sale tenures. 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 (about 65%) of the homes under development are for sale on the open market. Equally, a large proportion will be completed in 2019--at just over 55%. Therefore, in 2019, we expect Swan to generate more than 60% of its revenues from commercial sales.

We acknowledge that Swan possesses significant mitigation plans in case of market downturn, such as pausing or rescheduling development schemes, converting tenures from private sales to social rent, and pre-selling (about 30% of the "for sale" units over the next three years have already been sold pre-completion). We further note that regeneration development is carried out in small phases, about 150-200 units at a time, to mitigate the concentration risk of sales. In addition, regeneration of underdeveloped areas receives local authority support in most cases. For instance, 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 councils' interests in the successful delivery of the project. In another scheme at Oldchurch, Swan has de-risked associated sales risk by pre-selling all 65 units to one party prior to site completion.

Swan has recently ventured into building off-site modular construction and signed a seven-year £3.36 million lease for a new factory. This factory is expected to have moderate running costs of about £2 million, and management believes the production can be altered at a low cost if there is a change in the external economic environment. We will continue to monitor the costs incurred and the efficiencies gained from this initiative.

Our base-case forecasts indicate a deteriorating financial performance toward moderate levels, with adjusted EBITDA margins expected to weaken to below 30% by FY2019 from about 35% in FY2016; and relatively high leverage ratios of 13x-15x debt to EBITDA. We believe improvement in financial performance would be closely linked to the volume and valuation of open market sales, therefore we consider the overall strategy to be riskier.

Swan has recently issued a £60 million portion from its £100 million retained bond--the entire proceeds were used to repay a floating-rate loan--therefore total debt remains unchanged. The five-year average debt-to-EBITDA ratio is more or less in line with the sector average at about 13.3x; although we expect it to peak at slightly above 15x in 2017-2018 before returning to moderate levels. It is noteworthy that improvement in this metric is expected to come from an increase in EBITDA (and sales receipts), rather than deleveraging. Following the issuance of the retained bond, Swan will pay fixed rate on about 90% of its drawn debt and should maintain a healthy unencumbered asset base. We forecast Swan will have to rely on some element of sales receipts for its debt service needs in the forecast years from 2017-2019.

We view Swan's financial policies as generally prudent and in line with the sector. Swan's liquidity management policy requires sufficient cash and committed loan facilities, which can be immediately drawn down to cover the next three months' forecast cash requirement. Although we observe a somewhat slow response to Brexit in terms of updating assumptions, forecasts, and stress tests, we view Swan's long-term planning policies as strong.

In accordance with our criteria for government-related entities, we base our view of the likelihood of extraordinary government support 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. We positively acknowledge that the U.K. government has a track record of providing extraordinary support to the sector in the event of distress.

Liquidity

Swan has strong internally generated liquidity, with £157 million of cash sources expected to cover £115 million of uses by 1.37x over the next 12 months.

Sources of cash include cash and liquid investments of about £30 million, with a further £30 million of cash expected from operations over the next 12 months, and contractually committed facilities of about £95 million. Of this amount, £55 million relate to undrawn credit facilities and £40 million is from the retained bond that can be monetized--we note, however, that security has not yet been charged for this bond.

Capital expenditure pertaining to development of units to be sold is the major cash use over the next twelve months, about £95 million. The remaining £20 million will be required for debt service over the next 12 months.

Outlook

The negative outlook reflects our view that the rating could come under pressure if Swan's strategy continues to elevate the financial risk profile of the entity.

We could lower the rating on Swan over the next 24 months if the group's financial risk profile deteriorated, such that S&P Global Ratings adjusted-EBITDA declined structurally below 30% of revenues and vacancy rates remain sustainably above 2% of net rent receivable. We could also consider a downgrade if Swan's liquidity position materially weakens. We believe the impact on Swan's financial performance could be more pronounced in a downturn in residential market sales due to its larger exposure to open market sales and the concentration of risk within the group's development program.

We could revise the outlook to stable over the next 24 months if we observe 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.

Swan Housing Association Ltd Financial Statistics

	--Year-Ended March 31--				
('000 £)	**2015a**	**2016a**	**2017bc**	**2018bc**	**2019bc**
Number of units	9,986	10,203	10,207	10,241	10,515
Vacancy rates (% of net rental income)	2.1	2.4	1.8	1.6	1.6
Arrears (% of net rental income)*	3.0	2.7	2.5	2.5	2.5
Revenue§	82,303	109,576	109,504	118,089	199,980
Share of revenue from non-traditional activities (%)	43.3	53.1	45.5	49.2	69.4
Operating expense	52,977	76,063	81,178	89,747	153,196
EBITDA¶	32,511	36,512	30,952	30,788	49,420
EBITDA/revenue (%)	39.5	33.3	28.3	26.1	24.7
Interest expense	40,180	17,601	19,674	21,669	22,103
Debt/EBITDA (x)	15.2	12.8	14.5	15.3	9.3
EBITDA/interest coverage (x)†	0.8	2.1	1.6	1.4	2.2
Capital expense	45,367	17,455	16,999	27,758	16,141
Debt	493,429	466,322	449,837	471,895	456,895
Housing properties (according to balance sheet valuation)	685,270	703,738	741,543	765,873	778,392
Loan to value of properties (%)	72.0	66.3	60.7	61.6	58.7
Cash and liquid assets	20,109	14,853	5,097	5,264	20,640

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

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

- Swan Housing Association Downgraded To 'A' On Increased Sales Risk; Outlook Negative On Weakening Margins – October 31, 2016
- Credit FAQ: Brexit Uncertainties Mean Higher Credit Risk And Lower Ratings For The U.K. Social Housing Sector - October 31, 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