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Research Update:

Swan Housing Association Outlook To Negative On Increased Market-Related Activities; 'A-' Rating Affirmed

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

Secondary Contact:
Felix Ejgel, London (44) 20-7176-6780; felix.ejgel@spglobal.com

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Overview

- We project that U.K.–based Swan Housing Association (Swan) will maintain a high exposure to market-related activities, from which we anticipate it will derive more than 50% of its total revenue over the next few years.
- Swan's adequate financial risk profile is supported by its solid liquidity position, underpinned by funding linked to a strategic partnership with the Greater London Authority.
- We are revising to negative our outlook on Swan and affirming our 'A-' long-term issuer credit rating.
- 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 were to weaken its debt service coverage and liquidity. We would also lower our rating on Swan if we were to lower our ratings on the U.K.

Rating Action

On Dec. 12, 2018, S&P Global Ratings revised its outlook on U.K.-based social housing provider Swan Housing Association (Swan) to negative from stable. We affirmed our long-term issuer credit rating on Swan at 'A-'.

At the same time, we affirmed our 'A-' 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 negative outlook reflects our view that Swan's corporate strategy of deriving 60% 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, 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.

The 'A-' rating now includes two notches of uplift from the stand-alone credit profile, 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.

Although we recognize that this is a structural trend in the industry, in our view, it elevates risk and exposes Swan to cyclical and potentially more volatile revenue sources. We think that Swan's switch to deriving 60% of its revenue from commercial activities over the next few years will reduce its ability to withstand external risks. We consider Swan's future earnings to be less visible and predictable than those of a traditional housing association that mainly provides social and affordable rent properties.

The shift in business focus reflects a broader, sectorwide shift toward market-based activities, particularly outright sales and first-tranche shared ownership sales, and in Swan's case, private sales in East London and the southeast of England. Unlike traditional rental activities, these expose housing associations to the cyclicality in the residential property development sector. In addition, growth in this sector is less predictable than in social housing, given the significantly higher level of competition.

Based on Swan's current development plan, we forecast that revenues from private sales alone will account for nearly 67% of the total by the end of 2020. 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.

That said, 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 were just over 2% in the financial year ending in March 2018.

To date, Swan's track record in its development schemes has been positive. It has reported steady progress and good reservation figures for most of its ongoing projects. We consider the management to be 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.

One of the major risks that could ultimately hit the group's financials, in our view, is that buyers could pull out of sales when schemes are about to be completed. If there were a material slowdown in the real-estate market, we do not think Swan would find it easy to switch to market rent activities from outright sales. So many of the housing associations are adopting a similar contingency strategy that we see a clear risk of oversupply in the sector. Therefore, the low proportion of traditional revenues would effectively constrain Swan's financial performance, and could lead to a rise in debt levels.

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 development positively, 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. 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 relatively young, compared with peers. We view Swan's operational performance as strong, supported by low general needs tenants arrears, which stood just above 2% in FY2018.

Going forward, we expect that Swan's projected high exposure to market-related activities will weaken its financial performance, resulting in S&P Global Ratings-adjusted EBITDA margins that stand structurally below 30% of revenue, weaker than the 32% observed in FY2017 and FY2018. The costs associated with market sales are traditionally higher than those associated with lettings activity, and this weighs on profitability.

We expect Swan to take on some additional debt to fund its development program, such that debt to EBITDA will stand at more than 14x over the forecast period, higher than the 13x anticipated in our previous ratings review. We anticipate Swan's interest coverage ratios will remain robust, at 1.6x over the FY2019-FY2021 forecast period, in line with its peers in the 'A' rating category. However, we project that coverage from core social housing lettings revenue will gradually weaken and stand at just 1.1x on average over the forecast horizon. 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.

Liquidity

Over the next 12 months, we estimate Swan will maintain a very strong liquidity position on the back of additional funding recently contracted with the GLA. We project sources of cash to cover uses by about 2.8x.

Sources include:

- Current cash of around £14 million.
- Cash flow from operations of £45 million.
- Expected cash from sale of current assets of about £2 million.
- Undrawn contractually committed facilities expiring beyond 12 months of £80 million.
- Cash injection of £64 million, largely stemming from additional funding recently contracted with the GLA.

Uses include:

- Capital expenditure (capex) of about £25 million.
- Debt service (including interest costs) of about £48 million.

We view Swan's access to external liquidity as satisfactory, given its ready access to bank funding, but limited track record of issuance in the capital markets.

Outlook

The negative outlook reflects our view that the rating could come under pressure if Swan's development for sale activities weakened its debt service and liquidity coverage. We would also lower Swan ratings if we were to lower our ratings on the U.K.

We could lower the rating on Swan over the next 24 months if the group's debt service coverage ratios, including EBITDA interest coverage from social housing activities only, were to consistently decline. This scenario could be exacerbated by a correction of the housing market, which we anticipate would erode Swan's financial performance and liquidity. We could also lower the ratings if we revised our assessment of the likelihood of support that Swan receives from the U.K. government through the Regulator of Social Housing.

We could revise the outlook to stable over the next 24 months if we observe a sustainable improvement in financial performance, reduced appetite to develop for market-related activities, and a similar level of support from the U.K. government.

Table 1

Swan Housing Association Ltd. Selected Financial Indicators

	--Year ended March 31--				
(Mil. £)	**2017a**	**2018a**	**2019bc**	**2020bc**	**2021bc**
Number of units owned or managed	8,823	8,830	9,113	9,227	9,407
Vacancy rates (% of rent net of identifiable service charge)	2.2	2.2	N.A.	N.A.	N.A.
Arrears (% of rent net of identifiable service charge)*	2.5	2.2	N.A.	N.A.	N.A.
Revenue§	101.1	90.6	145.5	209.3	153.0
Share of revenue from non-traditional activities (%)	42.4%	35.6%	59.8%	71.8%	59.9%
EBITDA¶	32.7	28.7	38.1	47.9	39.6
EBITDA/revenue (%)	32.3	31.7	26.1	22.9	25.9
Interest expense	17.6	19.1	24.5	26.5	28.0
Debt/EBITDA (x)	14.7	18.0	15.7	12.5	15.1
EBITDA/Interest coverage† (x)	1.9	1.5	1.6	1.8	1.4
Operating costs	43.7	48.1	49.3	50.2	51.3
Capital expense	18.3	42.3	32.8	20.7	44.1
Debt	480.4	516.8	597.7	600.0	598.0
Housing properties (according to balance sheet valuation)	699.5	731.0	N.A.	N.A.	N.A.
Loan to value of properties (%)	68.67	70.69	N.A.	N.A.	N.A.
Cash and liquid assets	37.3	13.7	79.9	87.0	62.4

*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.

Ratings Score Snapshot

Table 2

Swan Housing Association Ltd. Ratings Score Snapshot

Industry risk	4
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Table 2

Swan Housing Association Ltd. Ratings Score Snapshot (cont.)	
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Financial policies	3
Financial profile	4

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
- Criteria - Corporates - Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 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

- U.K. Social Housing Association Ratings Under A No-Deal Brexit, Dec. 3, 2018
- Global Social Housing Risk Indicators: December 2018, Dec. 3, 2018
- Global Social Housing Ratings Score Snapshot: December 2018, Dec. 3, 2018
- Credit FAQ: How S&P Global Ratings Assesses Industry Risk For English Social Housing Providers, on Aug. 6, 2018

Ratings List

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Ratings Affirmed; Outlook Action
                                        To                 From
Swan Housing Association Ltd
 Issuer Credit Rating                   A-/Negative/--     A-/Stable/--

Ratings Affirmed

Swan Housing Capital PLC
 Senior Secured                         A-
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Additional Contact:
EMEA Sovereign and IPF; SovereignIPF@spglobal.com