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SCENARIO S-1 SINGLE PROJECT PROVIDER (CATEGORY 1)

Prepared for BC Non-Profit Housing Association and
BC Housing

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(Users should first read “Introduction to scenarios” document, which describes range of scenarios and methodology used to create them.)

SCENARIO S-1 SINGLE PROJECT PROVIDER (CATEGORY 1)

Scenario Highlights:

- Project has positive cash flow and well funded reserves and is fully viable

Options:

- Surplus cash flows combined with potential to intensify site offer opportunity to use surplus cash to leverage new financing and undertake expansion
- Merging with other small societies could increase potential leverage and create operating economies of scale

Project/Portfolio Description

This is a small society with only one project, serving seniors in a small coastal community. The project is a wood-frame elevated apartment containing 40 independent living units.

This community has a limited private rental sector (fewer than 600 rental units in CMHC survey universe), so rental options in the market are somewhat limited. The site is underutilized and could potentially accommodate an addition of 6-10 units, should demand exist. This opportunity is explored later.

As referenced in **Step C** of the EOA Planning Guide, the project should be assessed for social sustainability. For instance, there should be an assessment of continued need and demand of the housing this project provides, or for an expansion (page12).

Step A of the EOA Planning Guide recommends that societies carefully review the project operating agreement, to understand the conditions in the agreement. It is a Federal/Provincial funded project with the federal subsidy expiring in 2028. The project receives subsidy to cover operating shortfall.

Current theoretical viability

To avoid assumptions on inflation of rent and operating costs, the first assessment examines the theoretical outcome that would exist today if all subsidy and all mortgage payments are ignored. The following table summarizes the base line rents, operating costs and capital reserves, as reported in latest financial statements. For ease of reference these are shown on a per unit basis. The key variable for viability is the net operating income (NOI):



S1 Key Baseline Data (per unit)						
Per unit/month				Annual (per unit)		
Average rent	Average Operating costs (excl RR)	Replacement Reserve (RR) Allocation	Net Operating Income after RR	RR alloc per unit	NOI after RR	RR Balance per unit today
\$503	\$329	\$56	\$117	\$675	\$1,407	\$14,560

Rent and operating levels are healthy – with average rent per month of just over \$500. Operating expenses (before reserve allocation and excluding mortgage payments) are \$329, relatively low for social housing. The base year (2014) annual allocation to capital reserve adds a further \$56 to operating expenses. If the mortgage and subsidy ended today, the project would have a sound operating surplus (NOI of \$1,407) and would be viable.

The building is well-maintained and up to date on capital replacement and has a solid reserve in place for future replacement (with a balance of over \$14,000 per unit) and capacity to fund required capital renewal.

Expected situation at Expiry of Operating Agreement

As suggested in **Step B** of the EOA Planning Guide, this scenario uses the simplified Assessment Tool (SAT), which is available on the BCNPHA and BC Housing websites or through link on page 7 of the guide. After inputting base data into the SAT the tool generates a series of outputs based on two viability tests and an assessment of whether capital reserves and ongoing contributions are sufficient to enable the society to continue to maintain the property in sound condition.

As noted above, the cash flow analysis reveals that if subsidy and mortgage ended today, the project would be in a sound financial position, generating a surplus of just over \$1,500 per unit; and it has a healthy annual contribution to build reserves.

Building from the base data, the SAT projects viability and adequacy of capital replacement reserves (using a proxy threshold test) to assess the situation at expiry. The overall result is displayed in Figure 1, below. At expiry in 2028, this project is expected to have positive cash flow as well as sufficient capital reserves and falls into category 1.



Figure 1: Result of SAT Analysis

Overall Assessment Matrix		
	Capital reserves	
	Sufficient	Insufficient
Positive NOI	(1) Project is viable, can maintain current RGI market mix and has sufficient capital reserve	(2) Project generates a cash flow surplus, but asset is under-maintained
	S1 (2028)	
Negative NOI	(3) The project is not viable but has good reserves	(4) The project is not viable and replacement reserve is insufficient. Project is at risk

Exploring capital adequacy ¹

For the purpose of assessing capital reserves and capacity to manage needed replacements, the SAT uses a proxy value of \$1,500 per unit per year as a minimum required availability of cash from reserves and ongoing annual contributions.

In this project the annual contribution is just under \$700. However this is compensated for by a relatively large accumulated reserve. Together these create capacity to spend in excess of \$1,600 per unit per year.

A building condition assessment (BCA) has been completed and suggests a need for \$3.7 million in capital spending over the next 30 years. Once adjusted (by 50% to \$1.85M) this estimate for phasing and longer duration of some elements, the combination of the current reserve balance plus ongoing allocations reveal that the society has more than sufficient capacity to manage the capital replacement plan.

The net funding required going forward is in the order of \$385 per unit per year. This compares to the current expenditure of \$675. This suggests some potential to use the surplus to leverage financing for other purposes.

Review of challenges and opportunities

This project rates well and has few challenges. It does however have some opportunities, based on expected generation of operating surplus, potential for intensification on site, and a community with minimal rental options.

¹ In this assessment, the planned expenditure is based on 50% of the BCA annualized estimate. BCA's use estimated life of capital items, which may underestimate useful life. Furthermore, BCA's include components that are not practical to replace, and typically remain until the building reaches the end of its useful life (such as structural walls, branch wiring and foundation walls). Deferral, phasing and strategic capital planning based on financial capacity can be strategically used to lower actual spending requirements.

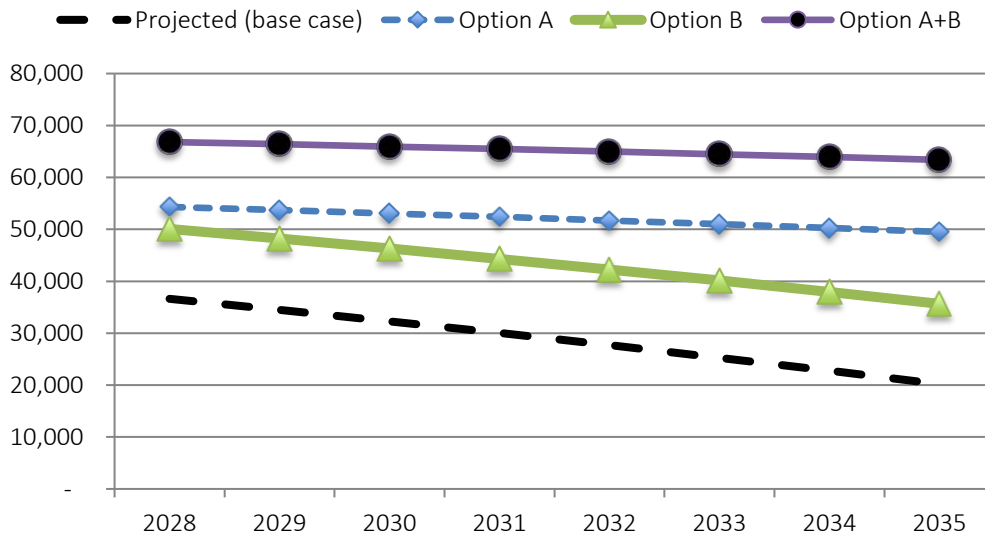


Exploring Potential Remedies and Options

As shown below, the project will generate a solid cash flow after expiry. Currently a generous contribution is being set aside in capital reserves (current balance is almost \$600,000, or \$15,000 per unit) and, with ongoing contributions, this will grow over time, even as replacement is undertaken.

Option A assumes that future increases in operating expenses are managed to a 1.5% annual increase (rather than 2%), which raises the expected surplus. Lowering the allocation to the capital reserve further enhances net cash available (Option B). Combining both steps almost doubles surplus cash to \$68,000 in 2028.²

Figure 2: Projected future cash flow, post expiry, alternate options



Creating new opportunities

Increasing the level of cash flow enables the society to leverage financing to take advantage of the potential to intensify on site. Potentially 6-10 new apartments could be added to the existing structure as an addition. Given few market options in this community these could be offered with a mix of affordable and market rents.

The combination of surplus available from ongoing operations plus new rental revenue are available to finance the expansion. For a discussion of refinancing, and redevelopment see pages 26- 27 of the EOA Planning Guide.

Under the base case, with an operating surplus of \$36,000 the project could potentially leverage up to \$400,000 in financing (assumes that 25% of surplus retained for an operating reserve with 75% available for debt service); under the more optimistic scenario (option A+B) the potential exists to leverage just over \$750,000.

² In developing this projection, the allocation to capital reserve is reduced as of 2014; in practice, the society should continue to allocate to the capital reserve, which will build that up by more than \$150,000 over next 15 years, then reduce allocation only when extra cash required, as discussed under the refinancing leverage option.



Assuming the addition contains a mix of 10 affordable and market rent units, and generated a net operating income (NOI) on average of \$400 per month (total \$48,000 annual for 10 units), the addition itself can also support some further financing.

Depending on loan term and interest rate this could generate a further \$500,000 in financing for a combined total of almost \$1.3 million. Construction and soft costs might approximate \$180,000-\$200,000 per unit (no land costs) so equity investment of a further \$600,000-\$800,000 would also be required.

Figure 3: Potential leverage to enable expansion/intensification

	Existing 40 unit post agreement	New 10 unit addition	Combined
Net Operating Income	66,800	48,000	114,800
Available to lever financing at 1.25 DCR	53,500	36,000	89,500
Retained for operating reserve	13,350	12,000	25,350
How much can you borrow?			
Assume financing rate *	5%	5%	
Loan terms (years)			
10	\$421,000	\$283,500	\$704,500
15	\$565,000	\$380,500	\$945,500
25	\$766,000	\$516,000	\$1,282,000

If government funding is not available, a further option, should the society seek to add to supply via an extension, would be to partner with other non-profit societies in this community, that also have small surpluses. Alone, each society may not have enough surplus to undertake expansion or new development but together their combined cash flow could enable more activity. This might be pursued through a formal merger to create a single larger society, with common objectives, or via a partnership agreement of some form. Shared services are discussed in EOA planning guide, page 23).

Legal, policy and regulatory considerations

Intensifying the project and adding new financing will require careful planning and approvals. Professional development expertise will be required. More information can be found in the “other resources” section of the EOA planning guide, page 37.

The existing zoning would permit the intensification, but formal application and approval is required. Refinancing will be easier if delayed beyond maturity of the existing mortgage. If this is undertaken post expiry when there is no remaining mortgage, the property could be refinanced. If pursued prior to expiry while the existing mortgage is in place, the existing lender (as well as BC Housing and potentially CMHC) must approve the additional financing and may impose some requirements, such as severance of the part of land being used for the addition, and indemnification of the existing mortgage lender.

While the existing and a new project have capacity to carry debt, underwriting requirements require some equity investment – it is unlikely that the society can proceed without some cash



equity, beyond the financing. The existing asset once free of mortgage debt would represent equity, but the project cash flows are insufficient to fully cover the development costs.

If the new units initially rented at full market rent, the net income and related leverage could be increased, reducing cash-equity requirements.

To the extent that the society will generate some operating surplus, recent actions by CRA have placed the “profit-generating” activities of not for profits under greater scrutiny (for more information, see page 11 of the EOA Planning guide). In this case, there are some operating surpluses generated and there is a risk that CRA may require the society to pay tax on surplus income. Legal and accounting advice should be sought to manage this risk.

Summary comments

This case is a well functioning project in a healthy operating position with sound reserves. It is fully viable at the point (2028) that federal subsidy expires, and no further provincial subsidy is required.

The project has the capacity to create an addition and add to the supply of market and affordable apartments in a small city that has a limited rental stock (and thus demand but limited competition). The requirement for cash equity may make it more feasible if the society is able to partner or potentially merge with another like-minded society in this community. Such a merger may also generate some economies of scale in administrative functions.