

S-2

SCENARIO S-2 SINGLE PROJECT PROVIDER (CATEGORY 2)

Prepared for BC Non-Profit Housing Association and
BC Housing

By Steve Pomeroy
Focus Consulting Inc.

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

SCENARIO S-2 SINGLE PROJECT PROVIDER (CATEGORY 2)

Scenario Highlights:

- Project has positive cash flow but underfunded reserves

Options:

- Remedies could include realignment of expenditures to improve funding for capital renewal and measures to contain inflation in operating costs

Project/Portfolio Description

This is a small society with only one project, built in 1990 (now 26 yrs old). Serving seniors in an Okanagan community, the project is a wood frame elevator apartment containing 34 units, including 6 fully accessible units.

Step A of the EOA Planning Guide recommends that societies carefully review the project operating agreement, to understand the conditions in the agreement. This example is a Federal/Provincial funded project with the federal subsidy expiring in 2026. 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 baseline 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):

S2 Key Baseline Data (per unit)						
Per unit/month				Annual (per unit)		
Ave 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
\$479	\$321	\$18	\$141	\$213	\$1,691	\$3,387

Rent and operating levels are healthy – with average rent per month of \$479, which is well below the average market rent of \$730 for a one bedroom unit in this community. Operating expenses (before reserve allocation and excluding mortgage payments) are \$321, relatively low for social housing.



The cash flow analysis reveals that if subsidy and mortgage ended today, the project would be financially viable (i.e. the current mortgage payment exceeds current subsidy, leaving a positive cash flow).

The remaining capital replacement reserve is relatively low (\$3,387 per unit), however annual allocations to this reserve (\$213 per unit in base year) are below recommended levels, such that the project is exposed to some risk of deteriorating condition (inability to fund necessary capital replacement).

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 already determined by the initial test above (situation today if no more mortgage and no more subsidy), at expiry the project has positive NOI but insufficient 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 the following overall assessment matrix. As shown in Figure 1 this project falls into cell (2) of the assessment matrix: it has positive NOI but insufficient reserves.

Figure 1: Results 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
		S2 (2026)
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

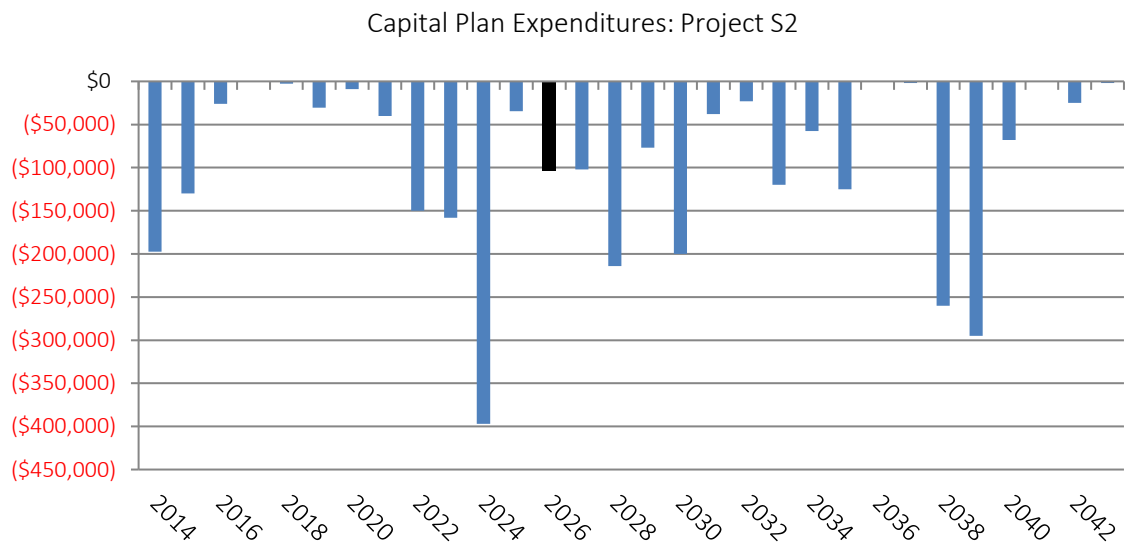
Exploring capital adequacy ¹

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. This can be more accurately examined if the society has completed a building condition assessment (BCA). In this case, a BCA is available.

The building is deemed to be in fair condition, but will require investment in some modest capital replacements as well as new roof and appliances within the next 10 years (prior to end of agreement and subsidy).

As shown in Figure 2, major capital spending is not even. Large outlays are required in certain years. Some of these can be smoothed out, for example phasing appliance replacement over a number of years, versus doing all in same year. Others, such as roof replacement must be completed all at once (unless separate buildings).

Figure 2: Capital expenditure based on completed BCA



The Capital Plan figure reveals the anticipated replacement, assuming all identified items are replaced as scheduled in BCA. In determining financial impacts the estimated expenditures identified in this figure have been adjusted downward by 50%.

A number of replacements, notably roofs are scheduled prior to expiry of subsidy (expiry year 2028 is shown in black shade). One option here may be to seek approval to increase contribution to reserves, which would require BC Housing to increase subsidy. Another may be to try and access capital grants under recently announced social housing retrofit funding (Federal Budget

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.

2016), or any subsequent similar funding source. Societies should, however, try to develop remedies that do not rely on government funding, in case this funding is not available.

Drawing on the detailed BCA capital plan and after counting the current reserve, the society should be setting aside roughly \$1,700 per unit each year. This compares to the current allocation of only \$213 per unit. This is clearly insufficient, and will result in under investment in maintaining the asset in sound condition.

Review of challenges

The primary challenge in this scenario is to ensure that the building is maintained well and that enough funds are set aside to enable any capital replacements, required due to aging components and appliances.

While the project is viable at expiry, with positive cash flow, the ongoing cash flow is reduced due to (assumed) faster rate of inflation in operating expenses (assume 2%) compared to rental revenues (assume to lag inflation at only 1%).

The other concern is that the current annual contribution to reserves leaves these under funded, especially in the period prior to expiry.

Exploring Potential Remedies and Options

Step D of the Planning Guide provides options to help improve post-EOA viability, and where necessary address underfunded capital reserves. The discussion presented here draws on those options.

In this case the positive cash flow creates an option to address (at least in part) the low allocations to and low balance in the capital reserves.

If this is not sufficient (as it is not), additional measures such as a modest increase in rents (above the 1% assumed in projections), may be needed. At the same time, it would be a good idea to explore other options to generate revenue and/or adjust expenditures.

These scenarios are concerned with post expiry viability, but it is not appropriate to wait until expiry to begin exploring and implementing remedies.

Options prior to expiry

Prior to expiry insufficient contributions to capital reserves limits current and future capacity to maintain the building in sound condition.

Option 1: Seek authority to increase contributions

While the project is still under an agreement and eligible for subsidy, one option is to seek BC Housing approval to increase the Replacement Reserve Allocation. To the extent that the project may be generating some operating surplus, it may be possible to ask BC Housing to retain such surplus and use this to increase the contribution to reserves. Any further increase in contribution (beyond self generated surplus) will directly impact BC Housing and increase their subsidy expenditure.

Option 2: Seek Retrofit Funding

Another way to reduce the growing capital plan impact is to secure grant funding under a social housing retrofit program.

Such a program is being implemented as a result of the 2016 federal budget and it is possible that similar funding could be extended or available in the future. This could potentially offset part of the accumulating capital need and lessen the remedies needed to address capital renewal, post expiry. Such retrofits also target water and energy efficiency; as such they may positively impact operating costs and help to increase any operating surplus (which can be allocated to reserves).

Options to take effect after expiry

The SAT assesses the impact after expiry so these options focus on that time frame, and explore remedies that providers can create and implement without BC Housing approval. It is suggested, however, that groups discuss these options with BC Housing, BC Non-Profit Housing Association or a local development consultant prior to expiry, and explore additional opportunities to generate revenue and/or adjust expenditures.

Option 3: Use surplus to increase annual allocations to capital reserve.

The SAT analysis projects a modest per unit surplus at roughly \$1,400 at maturity of the operating agreement in 2026, which creates room to increase contributions to fund replacement and/or build the replacement reserve after expiry.

Option 4: Increase rent revenues.

A modest phased increase in rents (especially if these are well below market) can help to increase surplus and capacity to fund capital reserves. Similarly, vacant units can be reallocated to tenants able to manage a higher rent.

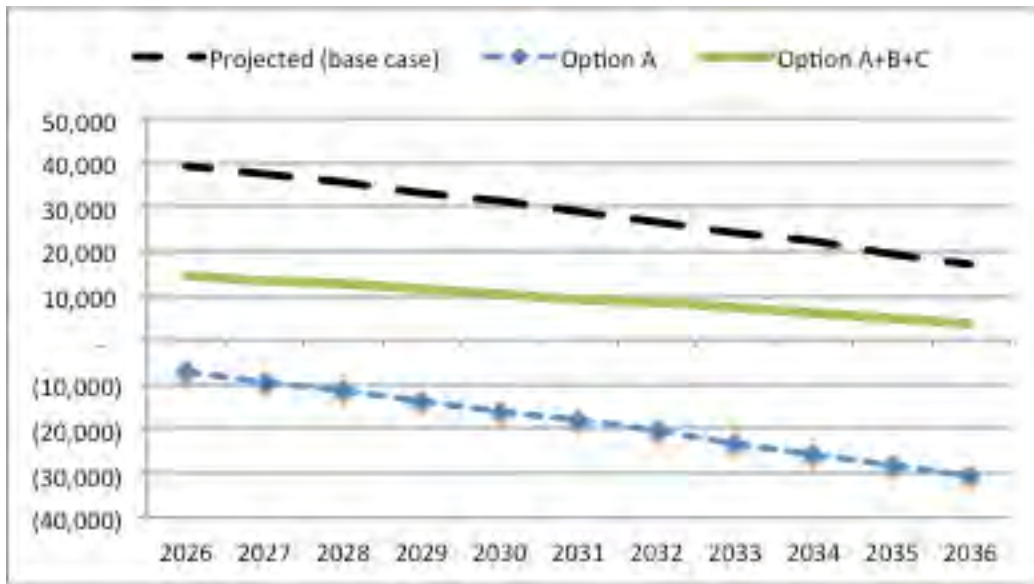
In the figure below, the base case reflects the expected situation at expiry. After the mortgage is fully repaid and subsidy ends, the project generates an operating surplus of almost \$40,000 per year. This declines over time as operating costs rise (2% p.a.) faster than rents (1% p.a.) but remains positive.

Reallocating operating surplus to increase annual contributions are bumped up to \$1,500 per unit (up from \$231 now, per unit) is shown as option A. This scale of increase is too large (exceeds annual surplus) and makes the project unviable. Potentially a smaller contribution (e.g. \$1,200 could be considered, but is not modeled here).

However, unless some retrofit funding is accessed to reduce residual capital requirements, the requirement is \$1,500 per unit, so this level should be targeted. To manage this requires either a reduction in expenses, (option B in exhibit assumes increase in managed down to 1.5%) an increase in revenues (Option C assumes rents are bumped up by 5% from current then increase annually at 1%) or a combination of these two measures.



Figure 3: Effect of implementing proposed options



The combined set of measures (A: increased allocation; B expenses held to 1.5% increase; and C small 5% bump in rents) show that the full capital requirement can be funded and the project remains viable, although at a declining rate – so close monitoring and ongoing measures will be needed.

Legal, policy and regulatory considerations

Any increase in reserve allocations before expiry of the Operating Agreement (EOA) may impact the total subsidy required from BC Housing. Accordingly, any option of increasing annual contributions should be explored with BC Housing.

If a rent increase is pursued, the society will be required to comply with the regulations in the Residential Tenancy Act with respect to notice periods, and the annual level of increase.

As noted above, recent actions by CRA have placed the “profit-generating” activities of not for profits under greater scrutiny (See page 11 of the EOA Planning guide for more information). 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.

Summary comments

In this case, the project is viable but needs to address the challenge of insufficient capital reserve and sub-optimal annual reserve allocations. It is suggested that societies should discuss annual reserve allocations with BC Housing prior to expiry.

Over time, the society must be diligent in managing inflationary impacts on operating costs to ensure that the project does not slide into deficit. The alternative is to monitor rents, relative to market and in the context of seniors CPP/OAS/GIS benefit levels (which are indexed).