EFDC DISCUSSION PAPER

1. DEVELOPMENT APPRAISAL AND VIABILITY TESTS

Principles of Investment Appraisal

Property investors appraise the viability of schemes by the investment method and determine viability via an evaluation of the long-term cashflow (buy and hold) as oppose to the usual Developer approach to private sale housing (build and sell).

It is the long term income produced by the asset that indicates the assets value to the investor.

The cash flow produces an assessment of the net income available over the funding period (Most RPs assess over a 25-30 year cash flow however different RPs appraise over different periods e.g 35yrs, 50yrs, 60yrs etcetera) to repay the private finance investment.

Investment Period

Many RPs opt for a 30 year investment period as:-
- stock generally requires major works or improvement after 30 years;
- loans are generally taken over a 25-30 year period; and
- predictions over this period are considered to be reasonably accurate. Once you start looking over 30 years, at 40, 50 and 60 year terms, the accuracy and therefore validity of the assumptions used begins to decrease significantly.

Subsidy

Affordable Housing does not work without a subsidy.

The income stream generated from the assets are not sufficient to cover the costs of acquiring the land, developing it out and running the properties.

Subsidy comes in various forms though the most important to RPs is government grant funding.

Grant & Internal subsidy

To compose the financial appraisal model we need to understand if EFDC intend to provide internal subsidy to make the schemes viable and if so what form will this take.

It is our joint aim to achieve investment partner status and by doing so access social housing grant from the HCA. However if funding is not forthcoming subsidy will be required.

<u>Internal subsidy</u>

Potential forms of subsidy:-
- The injection of internal subsidy from EFDC HRA;
- cross subsidy from developing private sale;
- cross subsidy from 'free land'.

There is also value in considering developing for shared ownership sale as this reduces the level of subsidy required.

Free Land

The land on which the Council House Building Programme is delivered has an intrinsic value. A decision around how this is accounted for needs to be made. It is usual that the land is valued and that value included within the appraisal however to make the schemes viable the Council may wish to discount the value of the asset or treat it as subsidy.

Viability Assessments

The financial assessments are generally a mixture of the following:-

i. NPV;
ii. Internal rate of return.
iii. Payback Year;
iv. Breakeven year; and
v. Rental yield.

Financial Tests

The five methods of assessing the financial viability are trying to determine:-

(i) Does the project add value to the Council?; and
(ii) Can the project repay its loan?

The above are usually decided by a combination of the five assessments methods mentioned coupled with other financial hurdles that must be met.

i. NPV

This is how the surplus or loss to the Council is measured.

NPV is the future net income (net rent, net receipts on sales or other income) the scheme makes, discounted to current values, less the initial project costs.

The net rent is the rental income less the Councils operating costs and is exclusive of the interest and loan repayments incurred.

NB For multi-tenure schemes the net income includes not just rent but also the receipts from sales e.g outright and shared ownership (and perhaps staircasing) over the appraisal period.

The initial project costs equate to the loan required and this is:-

Total Scheme costs (land, build, on-costs, interest) less grant subsidy and any sales income.

The discount rate applied takes full account of the cost of borrowing.

ii. Internal Rate of Return

This illustrates the return on the investment over the period. Crudely it's the amount of interest that would have to be earned on a deposit account to make the same gain over the period as is being made by investing the private finance into the scheme.

iii. Payback Year

Simply - how long it takes to repay the loans invested from the net income.

The net income previously allows for all the costs incurred managing and maintaining the properties over the term (as outline in the previous email) and includes interest charges. So long as the loan repays within a period the Council defines as reasonable (e.g. 30-35 years) it is considered viable.

iv. Break even year

This is pretty much as it sounds. The first year when the net rent charged exceeds the outgoings (service costs) and a surplus is produced.

This is a rather crude judgement of viability as it does not account for the changing value of money. *Exempli gratia* a loss of £50,000 in year one is not balanced by a surplus of £50,000 in year 7 as the cost of carrying that £50,000 debt for seven years is not accounted for.

The cumulative breakeven year is also used. This is the year when the surplus created is sufficient to eradicate the accumulated losses from previous years.

This is used because the long term cash flow assesses viability with fluctuation costs and as such schemes can move in and out of surplus. This is the result of varying inflation rates applied to the various assumptions e*xempli gratia* if the inflation rates for major repairs and maintenance costs are higher than those for rents.

v. Rental Yield

Simply the rental income expressed as a percentage of the capital investment required.

Generally RPs use a mixture the above. Usually NPV and breakeven year.

Even if a scheme passes a combination of the tests above and paybacks its loan within the 30 year period, is NPV positive and breaks even within an acceptable period it may still fail to be deemed a viable project is:-

(a) the cost to value relationship is unacceptable i.e. it costs more to build than it is worth; and
(b) the scheme requires an unacceptable amount of internal subsidy to be considered viable.

These may make the scheme unacceptable to the Council.

Cost to value – Costs should never exceed value for sale or shared ownership schemes but this is often the case for social rented schemes especially in Northern areas.

The question of why pay more for something you could buy on the market needs to be addressed if an Council makes such an investment decision.

Non-Financial Test

These are holistic and qualitative tests. Items a and c below are, of course, variations upon the theme which any developer and house builders assess viability but the added dimension for EFDC is item b, subsidy.

(a) **Fit with the Development Strategy**

The first and most important test that must be passed, even before a financial assessment is conducted is how does the scheme fit with the objectives of the organisations development strategy.

This will include but is not exclusive to:-

i. will or can the scheme meet the organisations design and quality standards *example gratia* space and spec levels which are above building control and HCA funding requirements, type of units e.g. some HA's may not want to manage 3b + flats due to management issues etcetera;
ii. Does the scheme provides the type of affordable product the Council wants to deliver tenure, unit type etc;
iii. If the scheme involves some type of market or sub-market product such as sale or shared ownership is there local demand? Is it saleable?
iv. Is the scheme politically acceptable? Will developing the site result in a public outcry?

(b) Subsidy

Is public subsidy available and if so is it of sufficient quantum? This is a major risk for any public body as subsidy is crucial and therefore a massive viability gap results if funding is not secured or lost.

Can EFDC mitigate this risk by allocating either free land, or subsidy from the HRA?

(c) Risk assessment
What is the impact of the scheme on the organisations wider business plan and are the identified and potential risks (political, to neighbours et cetera) involved acceptable to the organisation?

2. REVENUE & INFLATION ASSUMPTIONS

We assume that your operating costs comprise basically (a) management, (b) maintenance (planned and cyclical), (c) major repairs provisions, (d) voids and bad debts (e) service costs.

We need to define what EFDC assumptions shall be and will you allow the full cost or a marginal cost in the appraisal?

(a) Management costs - self explanatory

(b) Maintainance Costs

The figures that are generally applied by RP's to the appraisal of new build units are taken from the associations business plan. Day to day and cyclical maintenance (e.g. gas servicing, window cleaning, preventative planned maintenance, communal and external redecoration, inspections, and the management costs of delivering these services) are usually lumped together.

In my view this is not a particularly accurate way of dealing with these costs as cyclical maintenance costs tend to increase at RPI, perhaps slightly faster in property boom periods when building maintenance costs are overheated due to the unavailability of labour.

Day to day maintenance costs should start at virtually zero for the first 3-5 years and then increase at RPI plus 1-2%.

On this point it seems to be the majority case with large RPs that they vastly overestimate the cyclical maintenance costs. Normally levels are based upon the actual costs of carrying out works on their existing stock. In the case of most large London RPs the stock in question usually contains a high percentage of scattered, converted, street properties.

The cyclical maintenance costs of these properties is bound to be extremely high as they have to be individually scaffolded, window frames (usually timber) require frequent repainting, many of them, especially in historical areas, contain large areas of cement render that require frequent repainting and contractors tender on the high side for jobs that comprise scattered individual houses and small blocks.

In contrast 21st century developments utilise low maintenance components *exampli gratia*. UPVC windows that do not require redecoration, self-coloured render *etcetera*.

In addition new build estates do not require scaffolding every 5 years – if ever. The clearance of guttering and redec of communal stairwells suffice for modern developments.

A new build block of flats containing 50 properties has one roof as opposed to 50 individual street properties.

Tenders for CM works on a 200 unit estate will axiomatically be lower than the price for 200 scattered street properties.

(c) **Major repairs**

Most RP's use a major repairs provision in the financial model. This is a slow start provision for new build Starting at year 7 and increasing gradually over time.

It is based upon a % of the reconstruction cost per meter square.

This is a widespread assumption and is based upon a study conducted by the National Housing Federation.

(d) void and bad debts

These are usually 1.5%-3.5% for social rented stock, 0% for shared ownership and around 7-8% for intermediate and affordable rents. We shall need to get these data from you.

(e) services charges

This is an important issue to get right for EFDC when building the financial model as affordable rents are gross and include service charges therefore your nett income is rent less service charge. The Council cannot recharge to the tenant and these will therefore have to be defined and bare these costs.

Inflation Assumptions

These are critical assumptions.

Base inflation in the appraisal must be set (we link ours to the long term RPI forcast) and marginal rates need to be applied where appropriate to:-

- rent;
- service charges;
- voids and bad debts;
- major repairs;
- management costs; and
- maintenance costs.

Cost of borrowing and NPV discount rate

We would advise that the appraisal include your actual cost of funds (both short and long term) and the NPV discount rate matches these.

Appraisal methodology

We recommend that EFDC adopt a repayment methodology as opposed to a annuity method of payback. i.e. the scheme repays the debt through the nett revenue as it can covering interest payments initially followed by principal debt as and when the cashflow allows.

3. RECOMMENDATIONS

That the above is discussed on 24th January and the principles agreed;

That ET liaise with management, finance and property services colleagues to define the assumptions and insert these into the Economic Assumptions Framework (attached); and

That these assumptions are refined and signed off by the Director and Assistant Direcor of Housing (EFDC) (by end of February) and submitted for Cabinet approval (TBC).