

# SCENARIOS FOR MANAGING THE END OF OPERATING AGREEMENTS

Prepared for BC Non-Profit Housing Association and  
BC Housing

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JULY, 2016



## INTRODUCTION AND OVERVIEW

BCNPHA/BC Housing have developed a planning guide for non-profit housing providers to help societies work through the implications and opportunities arising from the expiry of their operating agreements.<sup>1</sup> The guide is available on both the BCNPHA and BC Housing websites.

As a companion to the planning guide, BCNPHA/BC Housing wish to provide alternative scenarios as a way to illustrate potential and alternative outcomes for impacted societies. Where relevant, the discussion and options presented in these scenarios refer to steps in the Planning Guide. A cross section of “typical;” cases is covered. Some may reasonably approximate your own situation, while others may not apply. Reviewing the different scenarios may provide useful insight to help you manage your own projects.

Each scenario outlines possible options that can be implemented both in advance of expiry and post expiry. It is recommended that societies engage with BC Housing, BC Non-Profit Housing Association or a local development consultant to review and discuss any potential options. It is also noted that BC Housing is currently reforming a number of operating programs and is aiming to provide more flexibility for housing operators five years before their agreements expire.

The scenarios have been developed using the BCNPHA/CHRA Simplified Assessment Tool (SAT), available on their association websites, as well as on the BC Housing Website.

The SAT uses actual data from each Society’s most recent financial statements and produces three tests:

1. An assessment of the situation that would exist if (hypothetically) the agreement (subsidy and mortgage) ended this year. This is a theoretic assessment, but by using today’s data avoids the use of inflating or adjusting rents, costs and reserves. It gives a quick wake-up call: if the project is not viable today, it is unlikely to be viable in future years, without some significant adjustment to tenant mix, rents or operating expenses.
2. Rents and costs are then projected to the year of expiry using inflation factors. To reflect the nature of fixed low income, rental revenues are inflated at a slower rate (1%) than operating costs (2%). Because costs increase at a faster rate than rents viability reduces over the remaining period (compared to test 1).
3. A rough assessment on the adequacy of current replacement reserves and annual contributions identifies whether the reserves and contributions reach a minimal threshold level.<sup>2</sup> This has been calculated based on a formula that assesses the likely available reserve funds if projects have been making sufficient annual contributions over their life.

For each society/project the current (most recent year financial year) operating data are used to identify key variables that help understand the project/portfolio situation. The key metrics used are net operating income (NOI), which reflects free cash flow after all expenses excluding

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<sup>1</sup> Expiring Operating Agreements: A Planning Guide for BC’s Non-Profit Housing Societies (November 2014)

<sup>2</sup> Replacement reserves refer to the separate saving reserve set up by each society to which contributions are allocated annually in order to build a reserve from which to fund capital replacement, such as roofs, appliance etc. The proxy assessment uses a minimum spending threshold of \$1,500 per unit per year. This is how much the project should have available for each remaining year of agreement, drawing on both accumulated reserves and annual contribution.

mortgage payment (of which there is none following expiry, unless refinance); and capital adequacy (reserves and contributions to cover capital replacement).

The simplified assessment matrix is then used to position each project in one of the four potential outcome cells and the expected situation at expiry of the Operating Agreement is then explained.

Based on the projected outcome as well as local context and other factors, different options are examined to show how the society might implement plans to alter the trajectory for post expiry operations.

In many cases there are both policy and regulatory considerations. Accordingly each scenario recommends that societies retain appropriate expertise and legal advice in developing and implementing potential remedies.

Figure 1: Simplified Assessment Test (SAT) Outcome Matrix

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
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

### Limitations on use of Test 3 (sufficient capital reserve test)

The minimum capital adequacy threshold was developed 10-years ago. It was initially estimated a minimum availability from replacement reserves and ongoing annual allocations to allow the project to have \$750 available to spend for each remaining year of the agreement.

Based on recent Building Condition Assessment (BCA) data this older proxy amount is no longer deemed sufficient. On this basis, the SAT tool (test 3) has been updated to use a minimum combination of reserve balance and annual allocations to be able to expend \$1,500 per unit/year over the remainder of the operating agreement period. The implication of this higher requirement is that a larger portion of any operating surplus will need to be allocated to funding capital replacement so net surpluses may be negated and in some cases projects may never generate sufficient cash flow to fully fund replacements. This will require careful review and prioritization of capital plans. These impacts and implications are discussed in each scenario.

Although the capital adequacy test has been revised to a higher threshold (\$1,500) this remains a rough proxy. It is recommended that providers undertake a formal building condition assessment (BCA) to help determine capital needs and to develop an appropriate capital plan. Where available BCA results have been included in the scenario discussions.<sup>3</sup>

<sup>3</sup> Step D of the Planning Guide provides options to help improve post-EOA viability, and where necessary address underfunded capital reserves. The discussion presented draws on those options.

### Caveat on using BCA data

When planning for renewal, some careful review and adjustment of BCA estimates is required. Typically the BCA cost replacement of all capital items is based on a life cycle that may underestimate actual useful life. The BCA may also include some 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.

## OVERVIEW AND SELECTION OF ILLUSTRATIVE EXAMPLES

Prior research has shown that the end of subsidy at maturing of Operating Agreements may create some viability challenges for some societies, but for many it also creates an opportunity to be innovative and creative.

This opportunity includes options to leverage their housing assets, both to fund modernization and in some cases to consider ways to increase the number of units they own and operate. This may also require some consolidation of societies/providers to create scale that may be necessary to realize potential options as well as achieving a more resilient and sustainable sector.

By thinking more strategically and collectively, individual societies have an opportunity to strengthen the community based housing sector to preserve and expand affordable housing opportunities. The proposed scenarios map out some of these options. They also identify some potential challenges and barriers, together with ways to manage these challenges.

This brief outlines the process used to develop each scenario and outlines a set of scenarios exploring different situations to illustrate how non-profit societies might respond under different situations.

The scenarios cover three single project providers and two small-medium portfolio providers. Actual data was provided through BC Housing but some adjustments to base data were used to simulate different outcomes. For each, the client type and built form as well as general location are included as market context.

The scenarios cover the following situations

- 1.0 Scenario S-1 Single Project Provider (with sound viability and well funded reserves). With operating surplus it has capacity to leverage financing and could support new development/expansion opportunities with this surplus cash flow;
- 2.0 Scenario S-2 Single Project Provider (viable but with under funded capital reserve);
- 3.0 Scenario S-3 Single Project Provider with negative cash flow but well funded capital reserves and projects in sound physical condition;
- 4.0 Scenario M1 – Small Portfolio Provider with a blend of projects, some that are viable but others not. Some also have insufficient capital reserves to keep up with capital renewal required (but since the net is positive it is shown here in category 1). The options to cross subsidize across the portfolio are explored;
- 5.0 Scenario M2 – Small Portfolio Provider with mix of viable and non-viable projects with underfunded capital reserves. Opportunities may exist to gradually increase rents, or make other budget adjustments to enhance viability, and potentially, to permit some leverage to fund expansion.

### Selecting an illustrative example.

By identifying characteristics in the descriptions above similar to your own you can identify one or more of the examples to learn about measures that may apply in your case.

It will help if you first use the Simplified Assessment Tool (SAT) to determine your status and into which category you fall. Some additional characteristics may also help:

If you are a *single project* provider *and*

- A smaller community – S1, S2, S3

If you are a *portfolio* provider *and*

- An urban strong market – see M1
- A smaller community – see M2

You can also select by category based on your result in the SAT

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
	Category 1: S1, M1 (part)	Category 2: S2 , M2
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
	Category 3: S3, M1 (part)	Category 4:

The scenarios may not be directly comparable to your society. However, they may have features and remedies that could be adapted to your situation, and so reading all the scenarios may help you gain insight and identify options.