

M-1

SCENARIO M-1 SMALL PORTFOLIO PROVIDER

Prepared for BC Non-Profit Housing Association and
BC Housing

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

SCENARIO M1 – SMALL PORTFOLIO PROVIDER

Scenario Highlights:

- This small portfolio has two viable projects and two with small operating deficits
- Capital reserves on two projects are low but can be easily offset by higher contributions and reserves on two other projects

Options

- Cross subsidization across projects can help address deficits but this action alone is insufficient Some realignment of expenditures to reduce reserve allocations is necessary
- Rents should be gradually increased on one project to erase its deficit

Project/Portfolio Description

This is a small portfolio in a Lower Mainland municipality. The portfolio totals 199 units in four separate developments, including three families oriented row developments and a senior’s tower. All were built in the late 80’s –mid 1990’s and reach the end of agreements between 2021-2025.

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 includes two unilateral federal projects that receive CMHC 2% mortgage write down subsidy, while the later two projects receive full subsidy to cover operating losses.

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):

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
M1-A	\$1,095	\$742	\$98	\$255	\$1,175	\$3,058	-\$945
M1-B	\$866	\$547	\$95	\$225	\$1,140	\$2,696	\$3,450
M1-C	\$403	\$349	\$129	-\$75	\$1,551	-\$903	\$4,457
M1-D	\$539	\$339	\$229	-\$29	\$2,744	-\$346	\$5,396

The earlier two projects were built as income mixed projects with only a small percentage of units as RGI and consequently generate strong rental revenues (together approximating \$1,000 unit/month) and positive NOI. The later two projects are 100% RGI and consequently have lower revenues, which in the absence of subsidy would generate negative NOI.

All make sizeable contributions to capital reserves on an annual basis and all but one (M1-A) have a small a modest reserve account.

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. 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 the projects fall into two parts of the assessment matrix: two are viable with sufficient capital reserves; and two are non-viable (negative cash flow) but have solid reserves. As discussed below, current annual allocations to reserves are high, and this is in part a contributing factor to the negative cash flow.

The phasing of expiries is such that the two with positive cash flow reach the end of agreements first, and this may generate some surplus from which to cross subsidize the later projects, in which federal subsidy ends in 2022 and 2025. The earlier projects have very healthy surpluses, even with inflating operating expenses; at expiry (2021) these approximate \$2,500 per unit (over \$200 per unit/month).

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
	M1-A & M1-B (2021)	
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
	M1-C (2022) & M1-D (2025)	

At expiry (test 2) the negative cash flow in projects M1-C and M1-D are not large (less than \$100 unit/month), and are, in large part created by large allocations to the capital reserve. The obvious solution is to lower these allocations, in order to bring the operations back into the black.

Test 2 (Cash at Expiry)

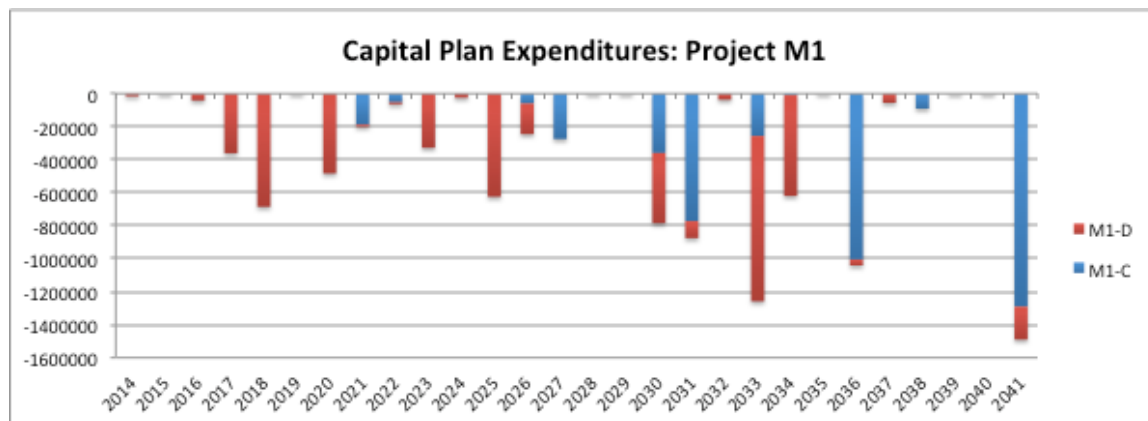
	Replacement Reserve per unit allocation base yr.	Yrs to EOA	NOI at EOA (before RR\$)	NOI at EOA per unit (before RR\$)	NOI Expiry /unit AFTER RR\$
M1-A	\$1,175	8	\$94,893	\$3,796	\$2,419
M1-B	\$1,140	8	\$246,586	\$3,574	\$2,238
M1-C	\$1,551	9	\$17,590	\$284	-\$1,569
M1-D	\$2,744	12	\$97,839	\$2,127	-\$1,353

Exploring capital adequacy¹

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.

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.

Figure 2: Projected annual capital requirements from BCA



Each property consists of family row townhomes and all have been well maintained and are in good condition. Normal replacement is anticipated, although one of the projects has some envelope issues. As shown in Figure 2, which reflects planned expenditures on two of the four projects, there are no major replacements in the immediate future, and those required can be readily accommodated within current reserves and annual contributions.

Review of challenges

The SAT analysis, complemented by the BCA reports reveals that overall this portfolio is in sound condition and operates in aggregate with positive NOI, although due to operating costs rising faster than rents, this surplus erodes and disappears after 2030.

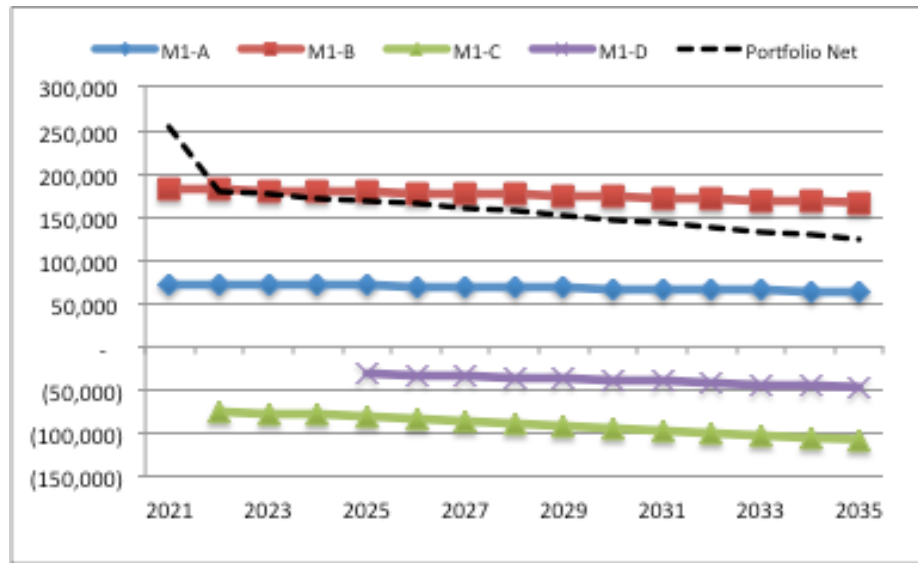
In this case the positive situation for the first projects creates an opportunity to allocate the surpluses that will be generated to cross subsidize the third and last project. To assess this potential for cross subsidization it is helpful to develop a portfolio wide cash flow projection. This can reveal whether surpluses and timing on one project are sufficient; or if additional adjustments are needed.²

The following chart reveals the respective post expiry cash flows for each project, as well as the aggregate portfolio total.

As expected, the first two projects have positive cash flow, but due to the assumed differential in inflation for operating expenses (2%) versus rent revenues (1%), the surplus declines over time.

² **Note on cash flow projections:** In undertaking the review and developing this scenario, data has been collected on each project. This however omits data on subsidy received and mortgage payments. These are deliberately omitted because the intent is to examine the situation once these are gone. This approach distorts cash flows prior to expiry and the cash flows used below do not therefore represent actual ongoing cash flow situations (they are theoretical net of subsidy and mortgage payments). There are however realistic representations of the post expiry situation of each project.

Figure 3: Post Expiry Cash flow projections, by project and aggregate



When M1-C expires in 2022, its larger deficit immediately bites into the aggregate surplus. This effect is compounded in 2025 when M1-D expires, however, surpluses from earlier two projects more than offset this and in aggregate the portfolio remains viable.

As a result, while two individual projects are not viable on their own, when operated as a portfolio with surpluses from two used to offset those challenges the portfolio is sustainable.

Exploring Potential Remedies and Options

Step D of the Planning Guide provides options to help improve post-EOA viability, and where necessary address the negative NOI in the later expiring projects. The discussion presented here draws on those options.

Options prior to expiry

Prior to expiry the large contributions to capital reserves are not an issue, other than imposing higher subsidy cost to BC Housing than may be necessary. It is not suggested that these be reduced, prior to expiry. This will enable the society to continue to build reserves. Because cross subsidies within the portfolio resolve viability no additional remedial action is required.

Options to take effect after expiry

In this case, by cross subsidizing across the portfolio, no remedial actions are required.

Legal, policy and regulatory considerations

Prior to adjusting annual contributions to the capital reserve, the society should consult with BC Housing, as this may have implications for subsidy received if implemented prior to expiry of the agreement.

BC Housing (as the existing approved lender) should be consulted prior to any option to refinance the asset.

Summary comments

This society has 4 well-functioning projects in sound condition, all expiring within a short period (2021-25). With minor adjustments (mainly related to allocations of surplus to capital reserves versus operating) the society should be able to sustain this portfolio and potentially can leverage the asset to fund additional housing activities (capital renewal or expansion).