

# M-2

## SCENARIO M-2 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 range of scenarios and methodology used to create them.)

## SCENARIO M2 – SMALL PORTFOLIO PROVIDER

### Scenario Highlights:

- A small portfolio combining a mix of projects with one that will be unsustainable and two viable but with underfunded capital reserves.

### Options:

- It is necessary to adjust operating expenses to help balance budgets and address underfunded capital reserves
- There is potential to cross subsidize between the positive and negative projects
- Viability across the portfolio requires some increase in rents and other budget adjustments

### Project/Portfolio Description

This is a small portfolio located on Vancouver Island, comprised of three projects totaling 42 units. The society serves a seniors population, with two properties offering independent living and the third offering special needs housing to non- senior adults (supported housing).

The Agreements and subsidy expire between 2021 and 2029, which gives the provider some time to plan and, if necessary, implement remedial actions. **Step A** of the EOA Planning Guide recommends that societies carefully review the project operating agreement to understand the conditions in the agreement.

- M2-A: 17 units for low to moderate income seniors, expires 2021. This project received a construction grant, is operating on a breakeven basis and receives no ongoing subsidy.
- M2-B: 13 units for seniors, expires 2026. The project receives ongoing subsidy for operating shortfall.
- M2-C: 12 units for adults with special needs, expires 2029. The project receives ongoing subsidy for operating shortfall.

For the first project (M2-A), at expiry, when the mortgage ends, there will be a positive impact (cash flow will increase by amount of mortgage payment).

The remaining two projects have both ongoing mortgage payments and ongoing subsidy, until the expiry date.

### 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):



M2 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
M2-A	\$267	\$166	\$71	\$30	\$847	\$358	\$7,002
M2-B	\$340	\$238	\$0	\$102	\$0	\$1,230	\$4,676
M2-C	\$318	\$376	\$0	-\$57	\$0	-\$688	\$2,751

Both rents and operating expenses are relatively low. Two of the three would have positive NOI if the subsidy and mortgage ended today; the third, however, is in deficit. All have a healthy balance in their capital reserves, but two have curtailed annual contributions, which will impair their ability to maintain the asset in sound condition.

#### Expected situation at Expiry of Federal Funding

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 p 7 of the guide.

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
	M2-A (2021)	M2-B (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
		M2-C (2029)

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. Based on the assessment matrix these three projects present three different situations to the society, and cover outcome categories 1, 2 and 4 (Figure 1). The phasing is in the same order, so the first to

expire in 2021 is in a positive situation with sound capital reserves and positive cash flow. While positive, the level of cash flow, on a per unit basis is quite low.

The average rent received per unit (in 2013) is only \$266, which seems very low relative to the average market (2013 Bach \$550, One-bed \$670) and relative to seniors' OAS/GIS benefit levels (which together provide incomes over \$1,400/month, so tenants currently pay well under 30%). There may be opportunities to raise rents a little, with minimal impact on lower income senior residents, or at least increase rents as units turn over.

The second project (M2-B) expires 5 years later and it too has positive cash flow, but has under-funded capital reserves, and did not make any contribution to reserves in 2013 (which is base for projection, so projected cash also excludes any allocations). The result is a healthy positive cash flow – so there is potential to rectify under contribution to capital, and gradual running down of replacement reserve.

The last expiry then occurs in 2029, and presents the greatest challenge – this project (M2-C) is neither viable nor does it have sufficient capital reserves to replace deteriorated capital components, as required. Similar to project M2-B, this project is also not currently (2013) funding replacement reserves (possibly because it is operating at a deficit).

### Exploring capital adequacy<sup>1</sup>

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.

Project A exceeds this level with \$1,625 available per year; however projects (B) and (C) have minimal availability of capital funds (each under \$300 per unit/year).

Capital requirements can be more accurately examined if the society has completed a building condition assessment (BCA). In this case, a BCA is available for the later two projects (which are the problematic ones).

The BCA reveals that annual capital renewal requirements will average almost \$50,000 (\$2,000 per unit). This far exceeds capacity, after taking into account the accumulated reserves. The fact that neither project is making an annual contribution is a cause for concern.

### Review of challenges

The critical issue in this portfolio is the underfunding of capital replacement reserves in two of the projects.

In this case the positive situation for the first project and duration of 5 years until the next expiry creates an opportunity to amass the small surpluses that will be generated. However, as

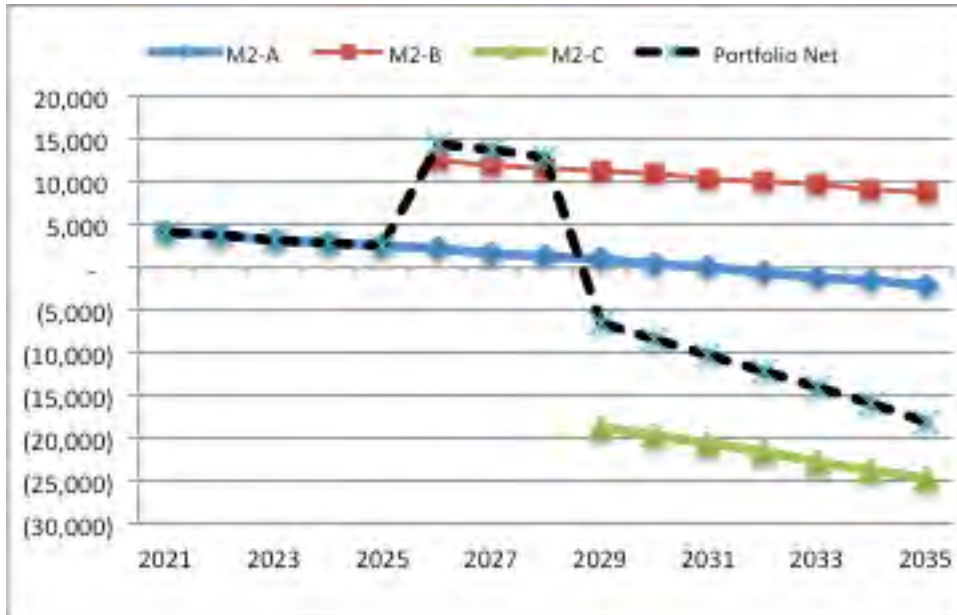
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<sup>1</sup> In this assessment, the planned expenditure is based on 50% of the BCA annualized estimate. BCA's use estimated life of capital items, which may underestimate useful life. Furthermore, BCA's include components that are not practical to 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.



illustrated in Figure 2, increasing deficits in project C cause the aggregate net income to turn negative by 2029. So remedies must include ways to augment revenues.

Figure 2: Projected NOI as each project reaches expiry of subsidy



### 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.

#### 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. Such retrofit funding can help to offset part of the accumulating capital need and lessen the remedies needed to address capital renewal post expiry. These 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.

The first step in examining options is to fully examine the cause of the situation each project is in. A few key data elements help to reveal the issues contributing to the deficit (presented above-key data).

In this case, the overall portfolio is at risk as a result of one small (12 unit) project (M2-C). Looking at base year data it is clear that this project operates with significantly higher operating expenses. This likely reflects the nature of the client group – these are special need units, non-elderly adults with mental health needs, with 100% of tenants receiving income assistance.

Rents appear to be set at the BC rent scale flat rent, so there is limited potential to increase these. On the operating side, it is possible that because of specialized services being provided, some non-housing expenses (e.g. support staffing, needed by specific client group) may contribute to the relatively higher expenses.

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.

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.

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.<sup>2</sup> This is presented above in Figure 2.

M2-A has positive cash flow, but this declines as operating expenses inflate faster (2%) than rent revenues grow (1%). This is a modest surplus, initially just over \$230 per unit, but declining to only \$120 by 2026.

At that time the second project (M2-B) reaches expiry and because there were mortgage payments but no subsidy this adds a further surplus, albeit an artificial one, due to lack of allocations to reserves.

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<sup>2</sup> **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.



Two years later in 2029 M2-C expires and adds its large operating deficit (total deficit at expiry of roughly \$15,000. This negates the surpluses of the first two projects and, as shown in Figure 2 above the overall portfolio faces significant negative cash flow. In addition the portfolio has insufficient capital reserves (although those for project M2-A remain healthy).

So in the short term, the society can get by, relying on the positive cash from the first two projects, but without some planning and adjustment the entire portfolio may be at risk. Some corrective action is needed and the provider must commence to plan and implement such remedies to manage the downstream risk and potential negative consequences.

#### Option 3: Seek support-care funding

Post operating agreement, alternative non-housing funding (i.e. care or community support) might be a potential source to offset the ancillary service costs that impair the viability of project C. Such sources and options should be explored as a first priority. Relatively minimal funding would be required, in the order of \$100 per unit per year (commencing in 2029 and inflating at 2% annually thereafter). This would be the best option and should be discussed with BC Housing and Health Region officials prior to investigating alternate options, such as those below.

#### Option 4: Increase rent revenues

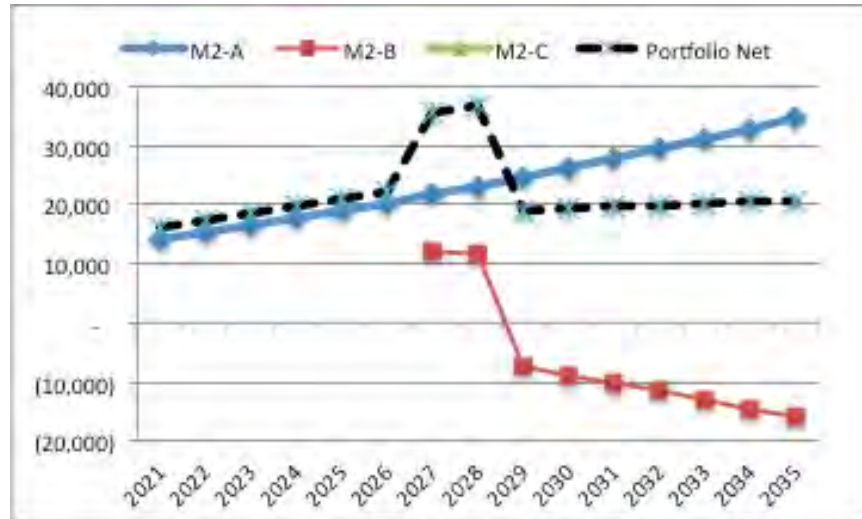
Project M2-A has the strongest potential since current rents are relatively low. This reflects the low operating costs and the requirements of the underlying program to operate at “break-even” rents. In this case, the operator has managed to be very efficient, and the tenants benefit greatly – rents are almost \$80 lower than the comparable project M2-B, and relative to OAS/GIS seniors income (over \$1,400 per month) these tenants are likely paying well under the 30% norm in social housing.

Project M2-A is a seniors project and given the level of benefits available to seniors via OAS/GIS and potential for residents to receive SAFER, there is room to raise rents gradually, and in the case of unit vacancies to raise rent for new tenants to levels closer to that in the rest of the portfolio. If an annual rent guideline increase (inflation plus 2%) were implemented beginning in 2015, it is not unreasonable to increase rents from \$267 per month currently to \$350 by 2025. In the event of vacancies the higher rent could be implemented at turnover.

Assuming an annual increase of 3% each year (at current rates this is less than the allowance of inflation plus 2%), with this relatively small adjustment, by 2029 just as M2-C is reaching the end of its subsidy, the annual surplus generated in M2-A will be in the order of \$24,500, compared to the shortfall on project M2-C of just over \$13,000. This translates into a per unit surplus of just over \$600.



Figure 3: Projected cash flow after implementing rent increase to project M2A



This is a healthy surplus and allows the society to restore annual allocations to capital reserves for M2-B and M2-C. Making such allocations will reduce the net declared operating surplus and lessen any risk that CRA may examine the tax-exempt status of the not-for-profit society.

#### Legal, policy and regulatory considerations

Any initiative to secure ancillary, non housing funding will need to be pursued via appropriate ministries – health or community services.

If a rent increase on the other project 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 a cautionary note, 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, rents remain far below market, so should not raise concerns, but it may be appropriate to secure legal advice as part of the implementation plan.

#### Summary comments

In this case, there are limits on what can be pursued in the project (M2-C) that will experience a deficit in the absence of ongoing subsidy. The fact that this project is part of a portfolio creates a unique opportunity to look beyond that challenge to more fruitful options in other parts of the portfolio.

With a relatively minor and gradual implementation of rent increases in project M2-A, rents will remain very affordable to seniors on OAS/GIS and far below market, while enabling the society to offset deficits in its higher cost special needs project and to restore appropriate annual allocations to capital reserves for the two projects that are under funded.

The key to this remedy is to commence the rental increases early so these can be kept modest and their effect can build up over time.