Making a difference...together

PPS/RH 2019-07

REPORT TO HOSPITALS AND HOUSING COMMITTEE
MEETING OF WEDNESDAY, JUNE 5, 2019

SUBJECT **Affordable Housing Investment Study**

ISSUE

A report summarizing the analysis of a program or structure capable of investing in affordable housing and preserving projects at moderately affordable rates, while also providing a return to investors.

BACKGROUND

At the September 27, 2017 meeting of the Hospital and Housing Committee, the following resolution was passed:

> *That the Capital Regional District advance an examination of options to support the establishment of a program or structure capable of investing in affordable housing, preserving projects at moderately affordable rates, while also providing a modest return to investors, including an examination of establishing a social purpose real estate trust.*

The Committee further committed funding in 2018 to support the initiative and directed staff to add this project to the Regional Housing 2018 Service Plan.

In early 2018, staff commenced a search for a firm with the specialized expertise in this field of business and in May of 2018, entered into a contract with New Market Funds (NMF) to complete an analysis of the alternatives. The project scope included examining the legislative frameworks governing these types of services, a risk analysis of options, a review of best practices, engagement with housing stakeholders, market testing with prospective investors and a summary of expertise and recommendations the consultant might have with respect to identified opportunities.

Phase I of the project included the consultant team reviewing and testing various approaches to creating such an investment structure. Initial findings pointed to the development of a Fund Partnership that operates as a form of social purpose real estate trust. In consultation with Capital Regional District (CRD) staff, in Phase II of the project, the consulting team have produced a report (Appendix A) that outlines two options for the CRD to consider:

a) Direct investment in housing development by the CRD using Municipal Finance Authority (MFA) funds; and
b) The CRD facilitating and potentially operating a Fund Partnership that would be open to private investors.

More research would be required in assessing actual investor interest, fund structure, return on investment issues and other taxation matters.

Funding for Affordable Rental Housing

In order to create new affordable housing, there are factors that need to be considered in creating a financially viable project. First, the organization has to determine what level of affordability it is trying to achieve. In order to lower rents within a given pro forma, an increased ratio of equity to debt is required to make a project viable. Generally, this is referred to as the debt service ratio (DSR) and, in affordable housing developments, the standard is to try to achieve a DSR as close to 1:1 as is possible.

There are four traditional streams that non-profit housing developers have used to create affordable housing:

1. *Capital Grants (patient capital)*: Capital grants are provided through the federal, provincial, regional and municipal governments for the creation of affordable housing (see Appendix B). In order for non-profit housing developers' projects to benefit from the grants, they must meet certain criteria, usually linked to affordability levels and client demographics. They have obligations created through operating/housing agreements and often require a covenant on title. Grants are non-repayable, although they often include terms where if you do not continue to meet the criteria, you must repay the grant.

2. *Equity contribution*: Non-profit housing developers will sometimes have equity that they provide to a project. This can be in the form of land, cash (fundraising or development reserve), and redevelopment of an existing property. Equity can also be provided by a partner such as through initiatives like the *Regional Housing First Program* or *the Provincial Investment in Affordable Housing (BC Housing).*

3. *Operating Subsidy*: Some federal and provincial supply programs will provide ongoing subsidies to the project in order to support the long-term viability. This is often in place of or in combination with a capital grant.

4. *Financing*: The remainder of the project must be financed. This financing can come from private financial institutions, federal or provincial financing programs offering discount rates, and Social Housing Banks. This debt is paid for through operating revenues which are mainly made up of tenant rents and sometimes operating subsidies. When borrowing funds, the institution must provide evidence to financers that the projected revenues ensure the mortgage will be paid long term and that the DSR will be as close as possible to 1:1.

   Examples of lower cost financing options include BC Housing's Community Partnership Initiative through which non-profit housing developments can access low interest financing. Similar financing is also available through private sector institutions such as Encasa Financial Inc., which has investment funds directly targeting social housing development.

   Through the CRD, capital for housing initiatives can be financed through the MFA. MFA debt financing costs can be leveraged through the CRD taxation authority and the MFA does not require a specific debt service ratio to be met. Debt financing costs would be serviced through proceeds from operations or would have to be covered through an increased requisition.

The greatest challenge for non-profit developers is to come up with the additional equity required to meet the required debt service ratio. Non-profit housing developers are often restricted from using surpluses from their other properties for new projects. They often have to rely on fundraising and in-kind donations. Grants provided by government often do not make up the equity required to meet the debt service ratio especially in the face of rising building costs and interest rates.

Proposed Affordable Housing Financing Structure

The consultants proposed the creation of an impact investment fund (Fund) for the purpose of facilitating an increased supply of affordable housing for low-and middle-income households.

The Fund would take the form of a limited partnership (LP) over which a General Partner (GP) would be responsible for the operation and oversight of the LP. The capital contribution to this structure would come from four sources: Government grants (patient capital), a non-profit equity, debt (borrowed funds) and the Fund derived from private capital that would require a return on investment (ROI) (see Appendix C for a summary of options).

The report calculates the ROI as well as a customized 'Social IRR' calculation, which is a measure of the rent savings from each housing project compared to the same project if all the units were rented at market levels.

The purpose of introducing private capital into this market would be to identify another source of funding that could be made available to make up the equity shortfall needed to make development projects financially viable.

<u>ALTERNATIVES</u>

Alternative 1:

That the "Affordable Housing Investment Structures" Final Report be received as information.

Alternative 2:

That the report be referred back to staff for further review based on Committee feedback.

<u>IMPLICATIONS</u>

This is a preliminary report covering a conceptual fund structure. The implications below are preliminary considerations as Committee considers direction on next steps.

Financial Implications

The purpose of introducing private capital into this market would be to identify another source of funding available to make up the equity shortfall for development project viability. Another benefit is that the LP would recognize that it takes a few years for a project to begin producing an operating surplus which allows for some flexibility in the timeline for collecting the ROI.

However, the need to prioritize ROIs above the affordable housing mandate puts the affordable housing goal at risk. ROIs are based on the pro forma estimates of net surplus from operations. If the net surpluses do not meet expectations, ROIs will still need to be paid regardless of the impact to affordability targets. This mandate could put the affordable housing goals at risk as well as creating risks for the non-profit housing developer to meet the terms of their operating agreements with capital grant providers.

Potential Investors

A few potential institutional investors were surveyed by New Market Funds to provide feedback on Phase 2 of the report. Some of the non-labour pension funds polled felt there was insufficient investment premium to be earned given the lack of liquidity and complexity of the structure and two labour pension funds wanted a longer investment horizon (20 to 25 years). The pension funds interested in the unlevered returns would require full control over the timing of the exit.

These divergent and conflicting demands would lead to stress on managing investor expectations which could put unwanted external pressure on the CRD.

Managing ROI

With respect to cost effectiveness, the LP structure as proposed, in concept, does meet affordability targets while also providing a return to investors. However, the return to investors is a cost in excess of debt or other traditional sources of capital financing.

The model proposes paying external investors approximately 5.0% to 6.0% on investment, which is an outsized risk-adjusted return when in fact there is very little risk to their capital. The private equity investor return is driven by an accrued investment return and a deterministic cash payout at exit based on a refinancing event in year eight. Hence, these investors take no true market risk. Their return accrues regardless of the underlying site cash flow performance.

Adjustments to the model's assumptions are required to assess potential changes in market conditions operational issues. A sensitivity analysis was performed on the model with the goal of assessing the impact on the leveraged return to private equity. Table 1 illustrates these potential changes, where shortfalls would impact project viability and ability to meet ROI expectations, and further affecting affordability.

Table 1: Factors that could impact non-profits ability to meet ROI

Projected ROI in Report	
LP Funds Projected ROI	**6.07%**
Projected ROI with Potential Changes	
Increase in Annual Operating Expenses: from 2.5%* to 10%	**3.49%**
Increase in Vacancy Rate: from 2% to 5%	**3.79%**
Increase in Annual Replacement Reserve Contribution: from 5%* to 7.5%	**4.15%**

* General industry standard

When considering Private Equity investment structures, a number of issues must be considered and addressed:

- Private Equity structures are generally the most expensive option. Fund manager fees in the private equity investment industry can range from 1% to 4% per annum (NMF was 1% per annum) along with additional one-time subscription fees upon raising initial capital (e.g. NMF was 1% of total capital raised).

- Private Equity fees are non-recoverable and don't contribute financially toward the CRD's mission long-term.

- Beyond paying investment manager fees, investor returns are targeted in excess of 5% which further increases the cost to fulfilling the CRD's mission.

Governance Implications

The report outlines caution regarding how financial investors will require assurance that their returns will be a top priority in managing the operations of the projects and management of the fund by the fund manager. It recommends the CRD Directors do not form a majority on the Board of the LP. It suggests, instead, to utilize a “mission lock” at the inception of the LP so the funds do not diverge from the CRD’s interests of investing in affordable housing. The mission lock element may mitigate this risk, however eliminating the risks entirely or the legal effectiveness of the lock would be difficult to guarantee. There is also a removal clause in the LP model, allowing the GP to be removed under certain circumstances which adds to the investment uncertainty.

CONCLUSION

The report commissioned by the CRD and completed by New Market Funds identifies a model by which the CRD could potentially establish an organizational structure capable of supporting investment in affordable housing while providing a return on investment to investors over time. It also lays out the costs of using MFA as an option for financing.

The report outlines how a LP approach could help address an equity gap in building affordable housing within the existing grant and capital funding environment in the capital region. Staff review, however, also takes into consideration governance and financial implications which helps identify several significant risks associated with taking the LP approach, particularly with respect to how changing market and operational conditions could substantially erode the capacity of the CRD to provide the prescribed return to investors while also delivering housing at a level affordable to low and moderate households. It would be prudent for the CRD to further consider these risks prior to taking further steps in advancing this model as it may wish to consider other means for filling the equity gap in order to better address affordable housing needs in the region.

RECOMMENDATION

That the “Affordable Housing Investment Structures” Final Report be received as information.

Submitted by:	John Reilly, MSW RSW, Manager Housing Planning and Programs
Concurrence:	Christine Culham, Senior Manager Regional Housing
Concurrence:	Kevin Lorette, P.Eng., MBA, General Manager Planning & Protective Services
Concurrence:	Nelson Chan, MBA, CPA, CMA, Chief Financial Officer
Concurrence:	Robert Lapham, MCIP, RPP, Chief Administrative Officer

JR:mk

Attachments: Appendix A - New Market Report
Appendix B - Patient Capital Grants
Appendix C - Comparative Options for Raising Capital