Development Appraisals

A financial appraisal should answer three questions about a project:

- **Is it viable?** Can we afford to do this scheme and what will be the impact on the business?
- **Scheme selection**: given a choice of schemes, which ones make the best use of the resources available?
- **Stakeholder's requirements**: does it meet the financial requirements of stakeholders eg Homes England (grant conditions) and lenders (covenants)?

Financial appraisal form part of a broader assessment, in particular the wider Development Strategy which determines geography, product, tenure etc. Quality is also an important consideration, particularly on an investment that is expected to pay back over many years.

Context – Financial Plan

Each year the board approves the Corporate Plan setting out the corporate priorities, and the Financial Plan which shows the forecast surplus and KPIs including covenant performance.

The Financial Plan makes assumptions about future Development in terms of scale, mix, revenue and costs – repairs and maintenance, management, interest costs etc.

It is clearly important that the assumptions used in the Financial Plan are consistent with those used in the appraisal of individual schemes, but also important to understand that a scheme presented for approval is using 'viability' assessments, and paints a picture of an individual schemes performance for assessment.

Note that the Strategic and Financial Plans also have to balance investment in new and existing stock. The latter will be influenced by stock condition surveys, compliance and the asset performance model which evaluates the financial performance of existing stock – these are all considered separately and outside the scope of this paper.

Different types of schemes

Housing association development has always included a variety of tenures:

- general needs social housing targeted at those that cannot afford market rents,
- supported housing to meet special needs
- low-cost home-ownership to assist more households to own their own homes ie shared ownership
- housing for outright sale
- commercial units such as shops, offices or workshop spaces
- properties at sub-market rents to house key workers who cannot afford to rent or buy in the areas in which their services are needed.

It is standard for housing associations to use different assumptions for different products for example, we have different management cost assumptions for affordable rent products and shared ownership properties, and similar for maintenance we will have sales costs in for the latter but not for the former. There is also scope to assume 'marginal' costs for some products for example additional affordable rent properties are not costed as the current actual cost per management unit, as assumptions are made on growth efficiencies.

Scheme appraisal methods

1. Break-even – the year in which the scheme moves from deficit to surplus with cumulative revenue exceeding cumulative costs.
2. Payback - with the reduction in grant, Development programmes require external funding and Payback is the point at which external debt finance is repaid.
3. Yield, and net yield - in the private rented sector, the most common method of assessing viability is "yield". This is simply the rental income expressed as a percentage of the capital investment required. Yield is most commonly used in considering the viability of commercial premises within a development, but is otherwise rarely used by HAs.
4. The use of Discounted Cash Flows to assess -
    - Net Present Value (NPV)
    - Internal Rate of Return (IRR)

    Discounted cash flow (DCF) analysis is a method of valuing a scheme project using the concept of the time value of money.

    All future cash flows are estimated and discounted by using the cost of funding to give their present values (PVs) in £. The sum of all future cash flows, income and expenditure, is the net present value (NPV), which is the value in £ of the cash flows in question. The higher the NPV the more attractive the scheme

    Internal rate of return (IRR) is a discount rate (%) that makes the net present value (NPV) of all cash flows from a particular project equal to zero. In simple terms, it is the amount of interest that would have to be earned on a deposit account to make the same gain over the period as is made by investing the borrowed finance into the scheme. It actually shows the long-term interest rate (or discount factor) required for the scheme to break-even in the longer term (ie to achieve an NPV Surplus). The IRR must exceed a minimum threshold, usually the long-term cost of funding. The higher the IRR the more attractive the scheme.

NPV, IRR and Payback are the primary appraisal criteria for most HA's.

Assessment period & approach

As grant has reduced and external funding increased, exacerbated by 1% rent control, the period over which schemes are assessed, and the minimum payback period, have both been extended across the sector. Typically, the minimum payback period ranges between 40 and 45 years. The longer the assessment period, the greater the risk that cost and income assumptions may prove inaccurate. It is important, therefore, that costs include appropriate assumptions for repairs, maintenance and improvements throughout this period.

Appraisals of schemes involving a mix of tenures with completion occurring in a number of phases, sometimes over a period of several years, is more complex. The development expenditure will overlap with the revenues once the properties come into management. To address this, the NPV of the development cash flows could be calculated on a monthly basis, and summed with the NPV of long term revenue cash flows calculated on an annual basis.

Taxation can be a further complication, hence the establishment of a DevCo for market sales and significant mixed use schemes with profits gift aided to the parent.

Sensitivity to key assumptions

Interest costs and Discount Factor

One of the key sensitivities of the appraisal model is the assumed long-term cost of funding which is itself used as the discount rate in the DCF calculation of all future income and costs.

In the past, the higher level of grant reduced the overall net cost of schemes, and the payback period. Payback within or around 30 years was consistent with the term of available bank funding. Interest costs and the discount factor could therefore be determined with a high level of confidence.

As grant has reduced, and the payback of 40 years+ exceeds the term of available funding – bonds are generally available for up to 30 years and bank debt up to 10 years. The assumed cost of future funding is more difficult to assess and subject to market volatility.

Inflation

Future rents are subject to political intervention. Some years ago, rent increases were changed from RPI + 0.5% to CPI + 1%. Although this was considered to be broadly neutral, recent experience has been that the gap between RPI and CPI has grown. The recent 1% rent reduction has compounded the issue. Cost inflation has exceeded growth in rent income and this may continue.

Other

Other cost assumptions have a more limited impact on appraisal outcomes.

A level of prudence should built into the appraisal assumptions, for example zero staircasing of shared ownership, lower end of market valuations, longer sales periods.

The assumptions should be reviewed at least annually following the update of the Financial Plan.