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Housing Learning and Improvement Network

Housing LIN

Can Extra Care Housing funding needs be met with funding from Institutional Investors?

This paper briefly outlines the challenges facing developers and operators of schemes that require external financing to bring them from conception to design, development and long-term stable operation.

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BACKGROUND

Finance is required for the initial Extra Care Housing feasibility work and approvals. Major finance is required for the development and then for the operation, usually the bulk being for the purchase of the building from the developer.

Finance is potentially available from interested parties' own funds, but this is likely to be limited. Government grants (centrally from Homes and Communities Agency, Department of Health and sometimes locally via PCT or other public bodies) are available and again these are limited and likely to be reduced going forward in the present economic climate. Major financing is also potentially available from charities, banks and institutions. The risks and returns expected from the providers of finance vary, but clearly the institutions and banks are commercial in their approach.

This paper explores the issues for the institutional investor and then provides a case study of how the potential future financing model for Extra Care Housing (ECH) could be developed to meet the expectations of all parties.

INSTITUTIONAL VIEW

The larger housing organisations have for many years raised funding from the well established corporate bond market, with social housing taking approximately 1% of the market with debt of over £11bn. These opportunities are only available to those individually or collectively raising very substantial sums, organisations wanting only a few million cannot take this route. There are also investment managers with different views, some favouring the sector liking the stability and steady income stream from rents underpinning the organisation. Others believe it is a small and relatively illiquid market area and not worth the resources to cover.

Institutional Investors broadly make equity and loan type investments with a view to balancing the risks and return on those investments both in terms of the liabilities the investments need to fund and the risks relative to different types of investment. Diversification of investments is important so if one type of investment performs poorly it is offset by another that does well. Liquidity will be an important factor for investors along with security of capital. At some point, investments need to be

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liquidated – turned into cash – to meet liabilities. The more easily an investment is turned into cash e.g. quoted equity, the more liquid it is. Lack of liquidity does not necessarily deter an investor, but the investor would expect to see a higher relative return for accepting the lack of ability to readily sell the investment into a trading market of similar investments.

Investors also importantly need to demonstrate that they have made investments that are primarily driven by fiduciary considerations and almost always use advisors to recommend investments.

CAN THESE INVESTMENT REQUIREMENTS BE MET BY EXTRA CARE HOUSING ORGANISATIONS SEEKING FUNDING?

Over many years there has been much debate on whether the requirements of institutional investors can be met by investing in social enterprise, or services that meet the needs of society, but cannot be fully funded by the public sector and do not have easy access to the established markets for raising capital which institutions operate within.

The Social Investment Task Force Chairman, Sir Ronald Cohen, commented in his April 2010 report.

> "*Over the last decade, there has been a significant increase in the flow of investment to disadvantaged communities and there are some encouraging developments in social investment, together with significantly greater interest from mainstream financial institutions as well as trusts and foundations. This has accompanied a shift in mindset and culture among voluntary sector organisations, which have become both more entrepreneurial and more focused on the sustainable achievements of their targeted social results*."

The Task Force identified some specific initiatives that would help future development:-

- Establishing the infrastructure necessary to create a dynamic market in social investment through initiatives such as the Social Investment Bank; and
- Creating new tools to deliver social change through financial instruments such as the Social Impact Bond.

Networks have been created over recent years forging the links necessary to allow investment funds to flow between private equity funds backing philanthropy initiatives, wealthy individuals and institutional investors directly into social enterprise. There should be opportunities for ECH schemes to take advantage of these opportunities when operating on their small scale.

The traditional funding of capital for ECH has come from grants, charitable donations and bank loans (see the Housing LIN Technical Brief No. 2, Funding extra care housing). The potential returns and the characteristics of the investment should be attractive to institutional investors, e.g. underpinned by secure rental stream or sale of units of leasehold ECH, and inflation type hedge for the liabilities. However, problems can arise due to the relative small size of the investment, lack of tradability in the investment and limited understanding of the potential.

Most institutions have consultants and advisers who act as "gate keepers" and they undertake due diligence on an investment and advise investors based on the suitability of the possible investment. This is a time-consuming and costly activity. Many regard it as not viable for small specialist investments.

As indicated above, much work has been done over the last few years to overcome the difficulties facing new small scale social type organisations seeking funding, but the area is still far from mainstream activity and is very limited in terms of the infrastructure capable of joining investors to social enterprise projects. For example, Social Finance Ltd was created

in October 2007 as a nascent social investment vehicle and has just launched a Social Impact Bond in respect of a scheme to reduce re-offending by prison leavers in Peterborough. It is this and committed individuals that will likely drive the acquisition of institutional funding for Extra Care Housing.

A case study provided by Social Finance Ltd demonstrates these points.

FINANCING EXTRA CARE HOUSING

Case study from ExtraCare Charitable Trust - June 2010

This case study is based on lessons from work undertaken by Social Finance Ltd for the ExtraCare Charitable Trust (ECT) in 2009. ECT develops, owns and operates Extra Care villages across the central regions of England, with a focus on developments of around 300 homes built around a community-centre style hub. Whilst specific operational models vary between different Extra Care-focused organisations, Social Finance believes that many of the underlying lessons are applicable to most scenarios.

Developments have historically tended to be funded by standard commercial banking facilities, yet this is not necessarily optimal for the entire life of a village or, in the current climate, as available as it once was. However, financing developments via the corporate bond market presents a number of issues:

- The bond market is not well set-up to purchase small size bond issues with unusual draw-down and repayment profiles and offers no flexibility to fit in with project variations; this would result in periods of substantial overfunding and thus unnecessary cost;
- Bond investors do not typically like to take development risk, particularly in the current environment, and reflect this in the expected returns when they do – for long term bonds the higher cost of funds remain payable long after the development risk has been eliminated;
- Most Housing Association bond issues are from well known, well rated organisations with an existing issuance program; a project-specific issue would be smaller, less liquid, less well known and lower rated (especially if the issuer is not an RSL) and thus more expensive.

The funding requirements, cash flow risks and project dynamics are substantially different between the initial development of a new ECH village and its long term operation. Social Finance believes that each phase should be considered separately to develop the optimal funding strategy for the overall life of a village.

DEVELOPMENT PHASE

The development phase is characterised by an initially growing and substantial cash flow requirement which entails a sufficient degree of uncertainty so as to demand plenty of flexibility in the timing and quantity of any capital disbursement. Indeed, there is significant value in having access to a facility which can be drawn as required – as is the case under a bank facility – rather than face the requirements of a bond where proceeds are drawn upfront and interest serviced prior to the deployment of the cash in the development. During the development phase the cumulative borrowing requirement usually peaks after 2.5-3yrs at which point the borrowings are substantially repaid from governmental grant income for completion of any rented accommodation (c.25%) and from sales proceeds for any owner-occupied properties (c.75%). This phase thus completes with a relatively modest long-term funding requirement to cover the residual difference which, in turn, can be serviced out of operational charges and rental income. (e.g. housing benefits) (Note, however, that the grant component can be large – perhaps 20% of the build costs – and thus has a significant

impact on the residual funding position. Should these grants cease to be available in the future, many villages may only prove economic to operate with an even smaller percentage of rental accommodation).

Senior Loan Facility

Given the requirement for flexibility and the availability of the property as loan security (albeit subject to project development risk) it is rational to utilise bank funding to the extent that it is available. Any such facility would likely be senior, secured and completely repaid at the end of the development phase (up to c.4yrs) by refinancing with long-term debt to cover the operational phase.

Despite the recent economic downturn, most of the social-sector banks and several of the commercial high street banks are still open to considering facilities with loan-to-value (LTV) ratios of up to c.60%, where “value” is defined as the amount spent on land and works. However, the margins currently charged over base rate are substantially higher than has been the case in recent years.

Mezzanine Debt Tranche

The bulk of the residual development phase funding requirement could be provided by a mezzanine debt tranche. The intention would again be to completely repay this capital at the end of the development phase with the long-term refinancing debt. The size of this tranche is limited by the amount that can be serviced and repaid within four years, even under stressed scenarios (development delays, slow sales, etc.) This tranche would be junior to and more expensive than the senior facility.

The mezzanine debt also offers the opportunity to be more innovative and discuss with investors how this tranche could interact with the subordinated capital discussed below. For example, the seniority and timing of coupons and notional repayments could be interlinked to tailor the risk-reward characteristics of each according to investor preferences.

Subordinated Development Capital Tranche

The subordinated development capital tranche is a new instrument, developed for socially-motivated investors who wish to help leverage senior and mezzanine lenders into the project. The capital would be drawn upfront and repaid after the senior and mezzanine, but again with the intention to completely repay the notional amount at the end of the development phase using the operational phase refinancing debt. The instrument would pay no coupons during the development phase of the project. Instead, investors would be paid a share of the future cash profits recognised each year through the resale of properties within the village over, say, the next 15-20 years.

Note that whilst this innovative tranche potentially opens up a broader investor group, it is currently untested. It may also prove unnecessary if the senior and mezzanine debt tranches can be sized sufficiently. An alternative and cheaper solution would be to find some providers of 0% loans / repayable grants, although capacity here is likely to be limited to existing charitable supporters.

OPERATIONAL PHASE

The operational phase of the village supports a far simpler funding solution. The stable, predictable and controllable cash flows make this phase an ideal candidate for long-term fixed rate debt – either in the form of a long-maturity bond sold to institutional investors or a termed-out bank facility. The high value of the underlying assets to the debt requirement should be attractive to lenders who would maintain a senior, secured position since any outstanding amount of the development phase capital should be repaid out of the proceeds of the one bond issue.

The quantity and maturity of debt required to refinance the development debt varies according to how smoothly that phase progresses, so the exact quanta would be decided at the time. Importantly, free cash flow from operations should provide substantial interest cover for this debt and the surplus profit should allow for ultimate repayment of the capital without requiring refinancing. (Note again, however, that lack of sufficient grant income for the development phase can lead to a higher operational phase debt quantum which can quickly exhaust this free cash flow). Note also that market conditions may make it more efficient to refinance for a short maturity and then refinance again in the future. In addition, multiple developments may, in time, lend themselves to being grouped together and refinanced en masse in the institutional capital markets.

The operational phase of the village would also be used to pay any property-linked coupons on the subordinated development capital tranche, as discussed above. Such coupons would be junior to the interest payments on the long-term senior debt. However, given that these coupons are a proportion of the actual cash received by the village for property sales, there should always be sufficient cash to make the payments unless the underlying village itself is being run at a loss.

FUNDING SUMMARY

The key findings from the above are:

i) Initial funding (loan size % based on total development cost)

- **40-50% commercial bank loan**: senior secured debt within development phase, flexible draw and repayment terms, LTV in 50-60% range to ensure commercial terms, repaid at end of development phase;
- **20% mezzanine loan**: junior debt within development phase, borrower-friendly terms to allow for late payment under stress scenarios, fixed interest rate, repaid at end of development phase;
- **5-10% subordinated development capital**: subordinated debt for social investors, zero interest bearing during development phase, coupons linked to future property returns during of operational phase, capital repaid at end of development phase;

ii) Refinancing (loan size % based on total development cost)

- **30-40% long-term debt**: senior secured debt within operational phase, long maturity, strong LTV and interest cover ratios to ensure commercial terms, fixed interest rate, repaid from free cash flow during operational phase.

For further information on Social Finance Ltd go to:
www.socialfinance.org.uk
Social Finance is Authorised and Regulated by the Financial Services Authority FSA No: 497568

The Housing LIN welcomes contributions on a range of issues pertinent to Extra Care housing. If there is a subject that you feel should be addressed, please contact us.

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