

A Private Retail Investment Vehicle for the Community Housing Sector

Sean McNelis
David Hayward
Hal Bisset

Sean McNelis MA BTheol is a consultant/researcher with Ecumenical Housing in Melbourne. He has over twenty years experience in the housing field, and has often provided leadership in policy development for the community sector. Sean has worked for both State and Commonwealth governments' housing departments and for the Victorian Council of Social Service.

David Hayward PhD is Executive Director of the Institute for Social Research at Swinburne University of Technology. His research interests include the funding of social policy, state government finances and housing policy. Recent publications include a co-authored introductory statistics book, and articles on the Melbourne housing market, the financial and social policies of the Kennett and Howard governments, and the relationship between privatisation and globalisation.

Hal Bisset BSc (Hons) DipEd BD is Executive Director of Ecumenical Housing. He has over twenty years experience in the community sector in the housing and homelessness fields. Hal is recognised as a leading housing assistance policy analyst. He has written numerous papers and articles in which he has tried to relate broader housing policy to the delivery of housing services designed to meet the needs of individual households.

Our Homes, Our Communities, Our Future
National Housing Conference 2001
Brisbane

INTRODUCTION

Over the past two decades, the State Housing Authorities have been keen to encourage private sector institutional investment in social housing to help compensate for declining Commonwealth funds. However, very little work has been done to encourage small-scale retail investment in social housing, although this category of investors is the mainstay of the private rental market.

The project tries to address this issue by focusing on the key question: How can retail investment be channelled into community housing at or below the current rate of return provided by the private rental market on terms that are acceptable to the specific needs of community housing providers?

This requires an understanding of both community housing managers and retail investors (as distinct from institutional investors).

THE INVESTORS

The investment market is complex. There are different investment vehicles– shares, property, securities, cash etc. – with different types and levels of risk. Elton and Associates (1998) identify two classes of investors: institutional and retail, to which McNelis (1999) has added a third class: social investors. Of the three, we know most about the first and the least about the last, for which there are no reliable estimates. The available data suggest that institutional investors have investments of approximately \$590b.

Table 1: Types of Managed Funds by Assets (as at 30 June 2000)

Type of Institution	\$b
Life insurance corporations	170
Pension (superannuation) funds	271
Public unit trusts	111
Friendly societies	6
Common funds	8
Cash management trusts	24
Total assets	590

*Source: ABS (2000: 56), using material from *Managed Funds, Australia* (ABS Cat. no. 5655.0).*

Table 2 is a preliminary and indicative estimate of the size of the retail market. Retail investors control almost \$400b worth of assets, compared to \$600b under the control of institutions. While it is undoubtedly true that the institutions are growing more rapidly courtesy of compulsory superannuation, the retail sector is a significant potential source of funds.

Significantly, there are different types of investors in the retail sector. While some are rational and go to great lengths to maximise their rate of return while balancing returns against risks, others are motivated by considerations including emotional attachments to property. There are others, such as many small private landlords, who have invested in rental properties because they intend to use their sweat equity to make a return.

Table 2: Types of Assets Held by Retail Investors ¹

Type of Asset	\$b
Rental dwellings ²	30
Cash and deposits ³	216
Securities (other than shares) ³	24
Loans ³	9
Shares and other equity ³	115
Total assets	394

1. The table is an estimate of those funds which households have available for investment purposes; it excludes assets such as owner-occupied housing, superannuation and life office contributions. These assets are excluded because they are already committed to one particular housing tenure (owner-occupied housing) or they are funds directed to and used by institutional investors.
2. Estimated on the basis of 689,400 rental properties with a median estimated value of \$125,000 and with an average loan of \$81,000 (*Household Investors in Rental Dwellings, Australia*, ABS Cat. no. 8711.0).
3. Financial assets outlined in *Australian National Accounts: National Balance Sheet Table 22: Households and Unincorporated Enterprises Balance Sheet as at 30 June 1997* (ABS Cat. no. 5241.0). These figures refer to both households and unincorporated enterprises.

PARAMETERS FOR COMMUNITY HOUSING ORGANISATIONS

Community housing is a distinctive form of tenure that focuses on low to moderate income households usually in receipt of rent assistance. It seeks to provide affordable and secure housing while keeping a sense of belonging in the local community and linkages with local support services.

These characteristics have implications for what dwellings community housing organisations (CHOs) acquire and where, the prices that can be paid for dwellings, how well they maintain these dwellings, what rents they charge, their interest in capital growth, the ways in which they finance the acquisition of community housing, the risks they are prepared to take, their capacity to build their asset base and their capacity to fund expansion through private investment.

A Financial Framework

There are two primary financial issues: capital financing and recurrent financing (ongoing costs and revenue).

Capital Financing

Capital finance, in particular private sector investment, is the central focus of the project. Broadly, there are two main options: equity and debt.

Equity Finance

Equity finance has three forms:

- Free equity where funds are provided by government, church or other organisations, either indefinitely or for very long periods without financial returns. These can be in the form of land or loans secured through mortgage, debenture or agreement;
- Social equity where funds are provided at less than market rates of return; and
- Private equity where funds are invested by a private investor with expectations of a market rate of return.

Free equity has been the major form of capital finance for public and community housing.

Investors can acquire a stake in community housing by:

- Acquiring dwellings and leasing them to CHOs;
- Jointly acquiring dwellings through a partnership with CHOs; or
- Investing in a special purpose vehicle which raises equity funds which are used to acquire dwellings that are leased to CHOs.

Debt Finance

Debt finance can be raised in a number of ways. One way would be to establish a specific purpose financial intermediary which raises funds for housing purposes by issuing housing bonds. These bonds can be either nominal rate securities or real rate securities.

CHOs can borrow funds in various forms: standard *credit foncier* loans, interest only loans, capital indexed loans, inflation indexed loans or low start loans.

Ongoing Costs and Revenue

Broadly, CHOs have to meet three types of ongoing costs:

- Operating costs such as administration, provision for vacancies and bad debts, maintenance and rates;
- Depreciation or provision for building refurbishment. This provision will enable the CHO to refurbish its dwellings over the long term. However, this is not applicable where the CHO does not own the dwelling. Where dwellings are acquired through debt finance, some or all may be allocated to debt repayment;

- Finance costs which include both the costs of capital and the accumulation of equity. These costs will depend upon the type and form of capital funds used by the CHO to acquire dwellings.

The level of ongoing costs is particularly related to the capital outlays of CHOs; where the price of acquisition is high, CHOs have relatively high ongoing costs.

For CHOs seeking to provide affordable housing, rental revenue is determined by one of three rental benchmarks. The maximum rent that a CHO can charge is a market derived rent.¹ Thus a 'steady state' financial position requires the CHO to keep its ongoing costs below market derived rents unless it receives additional subsidies to meet the difference. The market derived rent benchmark varies from dwelling to dwelling, with broad variations between states, between rural and metropolitan areas and between inner and outer metropolitan areas.

The second benchmark is the Australian Taxation Office (ATO) benchmark for GST-free supply of accommodation by charities. A CHO will only provide GST-free supply where the rent charged is below the ATO benchmark or where the CHO can show that the rent charged is less than 75% of market rent.

The third benchmark – the affordability benchmark – is related to a tenant's income, and is generally set at no more than 25% of income. Depending upon the level of income of tenants, this rent can range up to or close to market rents. As noted, this benchmark varies from household to household.

Analysis of the Target Group

The principal constraint on a CHO's financial strategy is the generally low incomes of their tenants. These are typically households who are in receipt of or eligible for rent assistance. Rent assistance is an additional payment made to recipients of Centrelink pensions, allowances and family assistance payments who are renting in the private rental market.

Financial Modelling and Rental Revenue

Three scenarios are modelled:

- The rental return to a private investor where the CHO is headleasing properties and charging market rents;
- The extent to which a CHO charging market rents can acquire dwellings through debt finance; and
- The range of house prices within which a CHO can operate while providing housing to the target group.

¹ The term 'market derived' rent is used, rather than 'market rent', to indicate that it is derived through an administrative process which seeks to establish what rent a particular property would receive in the private rental market, rather than through a process which actually tests the rent in the market place.

The first two scenarios highlight the parameters on capital finance imposed on CHOs by the market derived rents. The third, operating within the market rent benchmark, highlights the parameters imposed on CHOs' purchasing capacity by the affordability benchmark.

Headleasing

This section explores headleasing arrangements where the CHO manages dwellings and pays a market rent net of some costs to the headlesor.

Table 3 provides two examples, the first based on a property valued at \$150,000, the second valued at \$250,000. In this illustration, the net income return before finance costs and taxation to the headlesor (whether a retail investor, special purpose vehicle or social housing provider) is 3.38%.

This return does not include capital growth. However, it is the maximum income return which a CHO charging market rents can provide. A key question for the CHO is whether a private investor would consider this return to be adequate. In part, this will depend upon the extent of capital growth. Where capital growth is low, it is unlikely that this return is sufficient for private investors. Where capital growth is high, this return may be sufficient for private investors.

Table 3: Revenue-Cost Structure for Headleasing Properties

	% Property Value	Example 1 (\$150k House)	Example 2 (\$250k House)
CHO			
Income (market rent)	6.50%	\$9,750	\$16,250
Operating costs			
• Administration			
• Vacancies and bad debts	0.81%	\$1,219	\$2,031
Depreciation	0.00%	\$0	\$0
Rent	5.69%	\$8,531	\$14,219
Headlesor			
Income from CHO	5.69%	\$8,531	\$14,219
Less operating costs			
• Rates			
• Insurance			
• Responsive maintenance			
• Planned maintenance	1.11%	\$1,665	\$2,775
Depreciation	1.20%	\$1,800	\$3,000
Net income return before finance costs and taxation	3.38%	\$6,866	\$11,444

Market Rents and Debt Finance

Free equity aside, the main alternative to head leasing is for a CHO to borrow funds, but this imposes an additional financial burden in the form of debt repayments.

On the basis of the assumptions outlined in the Appendix regarding the housing market, depreciation, rental revenue and operating costs, the proportion of funds which a CHO charging market derived rents can borrow and remain financially viable is limited. Table 4 shows that a CHO can borrow up to approximately 40% of funds and remain financially viable. This table outlines for different loan proportions the surplus/loss (as a proportion of the house price) which a CHO would incur.

**Table 4: Surplus (Loss) as a Proportion of House Price
Where Loans Are Used as a Proportion of Capital Finance**

Loan proportion	30%	40%	50%	60%	70%	80%	90%	100%
Revenue	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
Ongoing costs								
Operating costs	1.92%	1.92%	1.92%	1.92%	1.92%	1.92%	1.92%	1.92%
Provision for depreciation *	1.20%	1.20%	1.00%	0.80%	0.60%	0.40%	0.20%	0.00%
Finance costs #	2.54%	3.39%	4.24%	5.09%	5.94%	6.79%	7.63%	8.48%
Surplus (loss)	0.83%	-0.02%	-0.66%	-1.31%	-1.96%	-2.61%	-3.26%	-3.90%

Assumptions:

* For calculation of provision for depreciation, see Appendix 1.

Credit foncier loan with 7.0% interest rates, with a term of 25 years

Even where market rents are charged, the extent of borrowing which a CHO can support, is very limited.

Tenants Receiving Centrelink Payments Only

The range of rents payable by CHO tenants receiving Centrelink payments is determined largely by the level of Centrelink payments. Column A of Table 5 outlines the highest affordable rents for each size of dwelling occupied by families whose only source of income is a Centrelink payment.

**Table 5: House Prices Supported by Rents Charged to Tenants
Whose Only Source of Income is a Centrelink Payment (Families Only)**

	A	B	C
	Highest Affordable Weekly Rent	House Prices (Assuming Rent Is a Market Rent)	House price (Assuming Rent Is Used to Meet Operating Costs Only)
2 bedroom dwelling	\$104	\$83,227	\$173,252
3 bedroom dwelling	\$166	\$133,323	\$277,535
4 bedroom dwelling	\$173	\$138,753	\$288,837

If this rent is regarded as a market rent, then Column B outlines the maximum house prices that can be supported with these rents. Where houses are acquired at these prices, then the CHO can support the maximum level of private investment. As the CHO acquires dwellings above these prices, more rent is directed towards operating costs and less towards finance costs (and supporting private investment). Column C shows the maximum house prices that could be afforded by a CHO renting dwellings to families on rent assistance, assuming that all of the tenant's affordable rental payments are used to cover all operating costs and depreciation. If a CHO acquires dwellings above these house prices, then they will require additional operating subsidies to meet their operating costs and depreciation.

There would be few if any appropriate dwellings available within the major capitals that could be purchased within the prices outlined in Column B. Those that might be in this range could be expected to be in poor condition and/or on the outskirts of the city.

As an example consider Table 4, which shows the proportion of properties in Melbourne that were sold in 1999 at or below \$150,000, at a time when property prices were up to 50% lower than they are today. The figures are broken down by region. In 1999, less than 8% of all dwellings sold for less than \$100,000, and of those almost all were in the outer suburbs. Today, it is likely that no properties in Melbourne would sell for less than \$100,000.

Table 6: Percentage of Properties Sold in Melbourne in 1999 at or Below Various Prices

Freq Range	Total Inner	Outer West	North West	North East	Outer East	South East	Mornington Peninsula	Greater Melbourne
\$60,000	0.3%	1.5%	0.8%	0.5%	1.2%	1.4%	2.5%	1.0%
\$80,000	0.4%	3.8%	2.5%	0.7%	3.1%	4.5%	8.5%	2.8%
\$100,000	0.9%	10.9%	7.0%	2.7%	7.0%	16.7%	16.4%	7.3%
\$150,000	7.9%	36.5%	38.0%	28.1%	44.7%	52.5%	37.8%	29.4%

Source: Valuer General unit sales records for 1999

Even if properties could be found at these values, the maximum debt that a CHO could support is 40% of these house prices. This begs the question of where the remaining capital is to be found.

CONCLUSION

To summarise: retail funds are a potentially significant source of capital for social housing. There are different types of investors in this market, some motivated by financial considerations alone, others interested only in bricks and mortar. There is little point in trying to attract those already investing in rented housing. The target must be those who are interested in financial products rather than real property per se. The problem is that these investors are astute and demand a return comparable to other investments, one which properly balances returns against risk. The challenge is to be able to find a sufficiently attractive financial vehicle that will harness these funds without compromising the principles of community housing.

As it stands, Centrelink payments are too low for this to happen. Significant subsidies will need to be found in the form of tax breaks to investors, capital grants to CHOs, new forms of ongoing subsidies, or a commitment by government to underwrite a community housing program such that risks to private investors are reduced to zero.

REFERENCES

ABS (2000) *Finance Australia 1999-2000*, Cat. no. 5611.0, Australian Bureau of Statistics, Canberra.

Elton and Associates (1998) *Financing Community Housing: Options for Private Sector*

Involvement: A Review of Existing Research, National Community Housing Forum, Sydney.

McNelis, S. (1999) *Private Funding Models for Church Community Housing*, Ecumenical Housing, Melbourne.

APPENDIX: RENTAL MARKET ASSUMPTIONS FOR MODELLING

Table 7: Housing Market and Depreciation Assumptions

Characteristic	Assumption
Market rent as a proportion of property value	6.5%
Building replacement value as a proportion of property value	60%
Economic life of the dwelling	50 years
Provision for depreciation	2% of building value or 1.2% property value
Allocation of provision for depreciation to building refurbishment fund (where less than 100%, these funds are allocated to loan repayment or lease payments).	Maintain a 'steady state' financial position [#]

The provision for depreciation will depend upon the free equity contribution from government and other sources. The formula for calculating the amount of depreciation allocated toward the building refurbishment fund is: if E^F is greater than BV, then depreciation is 1.2% property value; if E^F is less than BV, then depreciation is $1.2\%PV * E^F / BV$ where E^F is free equity and BV is the building value.

Table 8: Operating Cost Assumptions

Type of Operating Cost	Basis for Annual Cost	Example ⁺
Administration	10% market rent or 0.65% property value *	\$975
Tenancy management		
Vacancy costs	2% market rent or 0.13% property value *	\$195
Bad debts	0.5% market rent or 0.03% property value *	\$49
Property management		
Rates	0.45% property value	\$675
Insurance	0.15% dwelling value or 0.09% property value [#]	\$135
Responsive maintenance	0.25% dwelling value or .15% property value [#]	\$225
Planned maintenance	0.7% dwelling value or 0.42% property value [#]	\$630
Total operating costs	1.95% property value	\$2,884

* Market rent is assumed to be 6.5% of property value.

Dwelling value is assumed to be 60% of property value.

+ Example based on a property valued at \$150,000.