BlueCHP Limited

Submission to the Federal Government, Council on Federal Financial Relations – Affordable Housing Working Group Issues Paper

11/3/2016

Introduction

BlueCHP Limited (BCL), a Community Housing Provider (CHP), has a unique perspective on the social and affordable housing sectors. Our focus is entirely on the provision (property development) of affordable and social housing, while outsourcing tenancy management to other CHPs, a position in the market which provides a valuable perspective on the markets financial constraints. We have operations in both NSW and QLD and are at the forefront of large -scale innovative transactions. In its 8 year existence BCL has won property management and development contracts amounting to over 1,600 dwellings and retained ownership of approximately 650 properties on its balance sheet ($225m+). We are currently constructing 140 dwellings. In addition BCL recently won the Logan Renewal Initiative in Logan Queensland, which is a 20-year management and renewal project requiring a minimum of 2,600 dwellings to be built. BCL focus on property development means we have developed strong relationships with the banking community and raised over $87m of funds.

In responding to the options put forward by the Council on Federal Financial Relations in the Affordable Housing Working Group Issues Paper, BCL has sought to highlight the **practical steps required for improving the financing of the sector,** in particular the need for a low cost, long term debt market to support CHP's. BCL have **significant experience in the finance and property sectors** and have developed a sophisticated understanding of its constraints**.** BCL's own CEO, Charles Northcote, has over 30 years operation in global financial markets, extensive international mergers and acquisition experience and been responsible for the creation of two billion dollar organisations.

Background

The demand and shortfall of social and affordable housing in Australia is well known. BCL's own research, which utilises information from the NSW Auditor General's 2013 Report into social housing, information from the National Housing Supply Council and our own internal data show a significant shortfall in the supply of affordable housing. The figures in the table below provide a summary of this research and includes figures for social and affordable housing, which as the Working Group notes, can be defined together as Affordable Housing, or housing which is made available for low income or disadvantaged people. The table below shows that in NSW there is a shortfall of about 30,000 to 60,000 homes. At average cost of $350,000 per dwelling, this amounts to a $10.5bn to $23.5bn deficit. If NSW is a proxy for 35% of the economic activity in Australia, an investment of more than $35bn for affordable housing alone, would be required. When social housing is added, as the working group favours in its definition, the investment required is approximately $91bn. When including all forms of housing, including the renewal of existing social housing and allowing for **growth over the next 15 years, the amount of capital required is in excess of $100bn.** The resultant economic activity and long term benefits of providing affordable housing, of all types, are well documented by AHURI as well as other academic and government publications.

The Lack of Affordable Housing Supply in NSW	Dwellings	$bn
Lack of Supply Social Housing – no growth since 1996 except NBESP	32,000	11.2
Affordable Housing shortfall minimum	30,000	10.5
NSW Land and Housing Portfolio renewal 70%	84,000	21.0
Estimated shortfall	146,000	42.7
National Shortfall of Affordable Housing		
Estimated Shortfall National Shortfall Affordable Housing only	100,000	35.0
Estimated Social Housing Renewal @70%	225,139	56.3
Estimated Social & Affordable Housing Costs	325,139	91.3

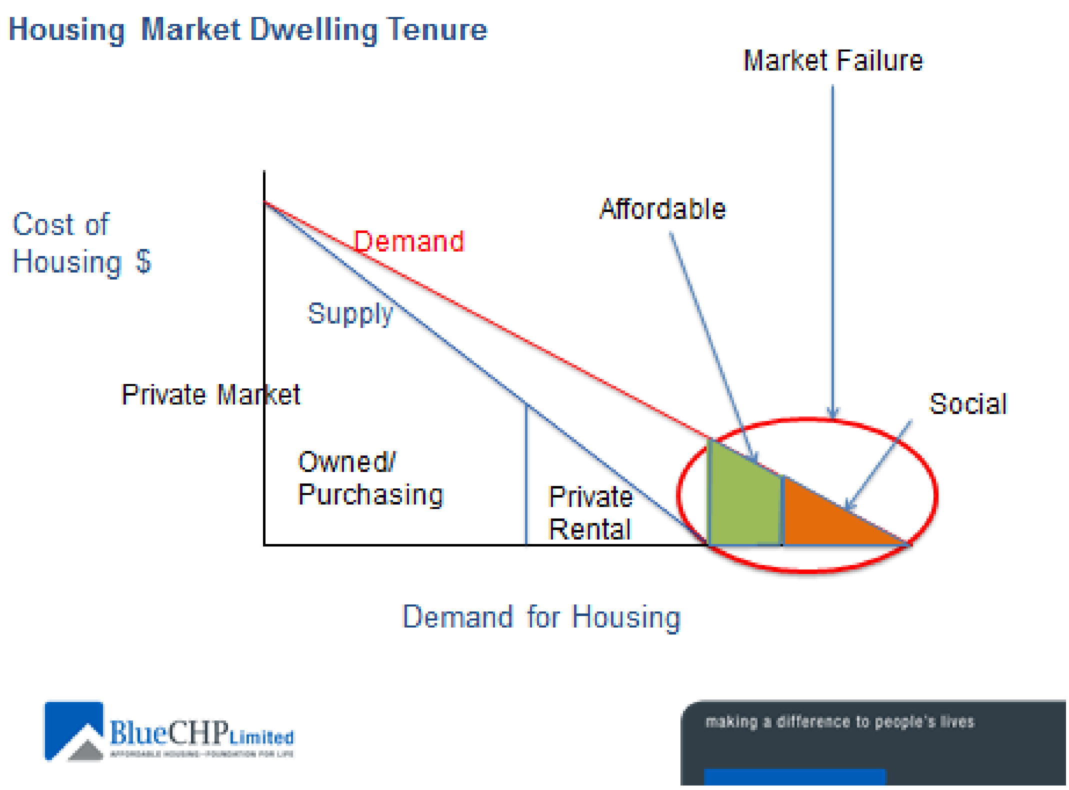
Whilst the number of required dwellings, 325,139, initially seems large, the annual housing starts in the last year were approximately 200,000, which means the shortage of affordable housing represents about 2 years of supply. The increase of 100,000 of affordable housing particularly in expensive markets of Sydney and Melbourne would make a significant impact on the availability of the affordable market segment and take significant pressure off social housing. A realistic delivery timetable would be between 7 to 10 years which would see an average of 30,000 homes built each year. Finally, the data provided covers existing shortfalls, not future projections. If the **Australian population reaches 30 million over next 15 years, as expected, it is estimated,** on a pro-rata basis an additional **50,000 affordable homes, costing $17.5bn**, will be required**.** Unfortunately, state bodies have all failed to renew stock in line with demographic changes and, since about 1996, failed to increase supply, with exception of the Nation Building Economic Stimulus Plan.

In addition, state governments have failed to keep housing stock up to high quality standard due to budgetary constraints over the past 50 years. CHPs are not subject to these issues and in fact are required to keep their housing to a high standard of repair. The rationale for handing stock over to CHPs is therefore compelling. State governments however have been reluctant to do this, a reluctance well demonstrated in the time it has taken government to meet the 35% target agreed to at COAG in 2009. CHPs have more flexibility when it comes to managing stock and can trade its portfolio to achieve a better mix of housing, which will be increasingly important over the long term to keep housing stock in line with demographic changes. The issue for all state housing bodies has been the lack of sustainability and growth. Government could benefit by transferring more stock to the CHP sector, which would see a substantial reduction in costs and liabilities, essentially because those liabilities would transferred off the government's balance sheet. This transfer would also support the growing maturity of the CHP sector and over time the required financing mechanisms.

This approach would also provide strong economic and social benefits for local communities. The Logan Renewal Initiative in Logan Queensland is to date the **only large scale, sustainable housing renewal program.** The program returns to the State government significant value. For each dollar invested a return on $3 is returned by way of new and increased housing supply. The regional structure, which sees all government owned affordable housing in the Logan LGA transferred to the non-government sector, will result in more than 2600 new homes built over a 20 year period. The regional structure and resulting scale is essential for the projects funding and risk management.

Although the purpose of this paper is to address access to finance, the Working Group should be aware of other factors, which over the past 5 years have been impediments to progress;

- Access to long term cheap finance
- Access to land supply
- Adopting a planning framework to mandate inclusionary zoning (i.e. percentage of affordable housing in market housing developments) excluding South Australia
- Addressing population growth and demand for housing
- Sufficient capitalisation of CHPs by state and federal governments
- Lack of coherent State Social Housing policies



Financing the sector

The fundamental issue for CHPs and other housing providers is the mismatch of asset life to liability tenure, which results in CHP's facing **the risks associated with debt refinancing and changes in interest rates.** At the moment, optimistically, debt can be raised for up to 10 years, whereas asset life is up to 50 years or more. These risks mean CHPs have to retain higher levels of interest rate cover (ICR) (EBITDA/Interest Costs = interest rate cover ratio) than should be necessary. Refinancing risk usually costs between 100 to 200 basis points – on $50m financing this is between $500,000 to $1,000,000, equivalent costs to several dwellings. On that basis a CHP would have to refinance 4 times in 20 years which becomes very expensive. CHPs in addition to the refinancing risk face the impact of interest rate risk. The variability of interest rates over the past 30 years has ranged from 18% to 2%, resulting in organisations having to operate with higher levels of ICR. BCL aims to operate with an IRC ratio of 2x or greater. With predictable, long term fixed interest interest rates ICR could be as low 1.35x. Refinancing risk can also fluctuate depending on the time of the business cycle, where for example, the GFC resulted in a very tight funding market and high costs, while in comparison markets are now more benign. The majority of finance for the CHP sector is raised from the banking market, which is very liquid, but the imposition of higher capital requirements (Basel III) is forcing banks to pass on costs, and limiting finance to a maximum tenure of five years.

The importance of creating **a simple transparent and well understood product** in the market is therefore paramount. Creating a debt product would enable rating agencies to easily assess the risks of these instruments. The creation of a bond market in this way would be attractive to superannuation investors as it would be of sufficient scale, while also being linked to a predictable revenue stream, which is a mix of government revenue (welfare benefits) and market rents. This income is attractive and secure because of low vacancy rates and its indexation at CPI or slightly higher. Based on these fundamentals, a long term bond market is possible and as the market matures, **liquidity would improve with new participants, reducing the costs of administration**. In the initial years the market would require government support, probably through credit support (guarantee) and initially, due to the size of CHPs, a model similar to the British, Housing Finance Corporation (THFC), which makes loans to regulated Housing Associations, and is funded through the issue of bonds to private investors, would be required in Australia to pool sufficient debt. Over time and with scale CHPs would be able to issue debt in their own right as is done overseas. BCL has already done a significant amount of work on this issue with its partner Power Housing Association.

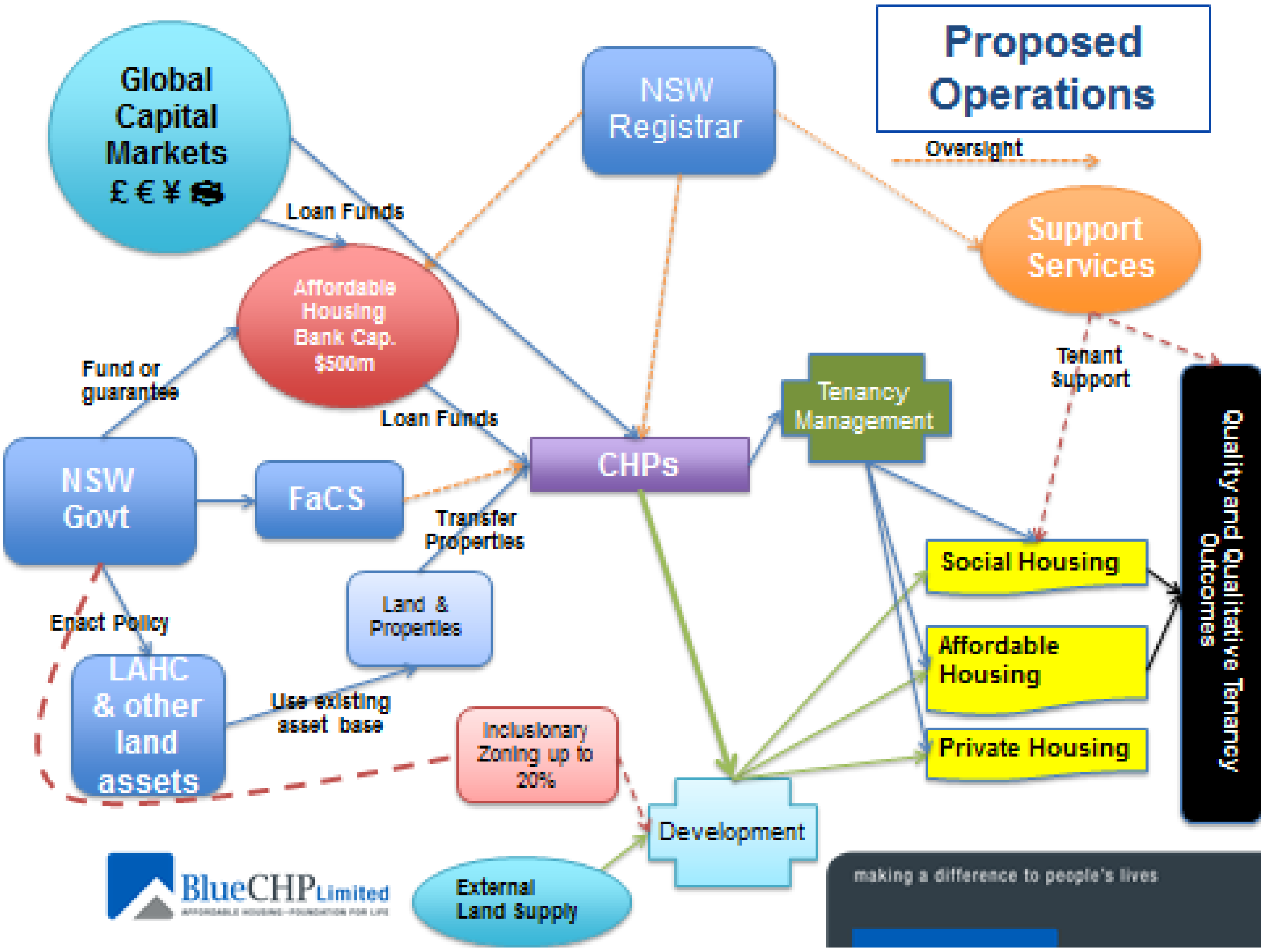
BCL has also been working with Power Housing to explore the practicalities of a bond issue. The key factor in this transaction is the need to issue in **Australian dollars, which is required to avoid exchange rate risk**. Investigations to date indicate a large scale appetite for the 20 year plus tenure and this could easily be achieved in the sterling and US markets. However, to be successful and to be able to issue a bond in Australian dollars, a guarantee from government would initially be required, support which would correct the current 'market failure' and establish the market. During the GFC the British Government provided credit support to the sector and housing associations, with THFC able to achieve very competitive pricing at the time. BCL believes that once the market for this product is created Pension Funds (local and overseas) would support the product and after an initial period of about 5 years the guarantee would not be required, largely because the market would have come to understand and accept the product. BCL notes the appetite for Canadian and US pension funds for Australian assets, particularly infrastructure assets of which affordable housing can be categorised. The provision of a government guarantee should be seen in the context of its broad economic value, job creation and social benefit for those in need.

The Logan Together Initiative in Logan Queensland recognises that quality affordable housing is integral in achieving social outcomes for tenants. In Logan the aim is of raise NAPLAN scores to be at or higher than the Queensland average. Beside education there are flow-on benefits for health and a reduction in crime. This is where impact investing on scale can really benefit the community in the long term, meeting the federal government objectives of reducing welfare, education and health costs. The creation of long dated debt instrument would also provide opportunities to participate in **shared equity products** supporting people to get into home ownership. BCL notes that there is still a real need to support people on the initial journey of home ownership and there is currently a dearth of such products. BCL has partners with significant expertise that could be launched into the market with the right support. Working with UK partners we have models ready to launch, but are restricted by the lack of long term debt availability. The ability of long term debt would enable BCL to provide equity models that enable people to enter into the housing market. The long term debt market described would provide the certainty required to structure and offer these products in Australia.

The CHP sector has a distinct advantage over the private sector, it does not have to pay out shareholders, and its profits are reinvested in the sector, creating a virtuous circle. As CHPs are operating in the segment of the market where there is 'market failure' the levels of economic return are lower than that justified by the private sector. The financial covenants (1.1x to 1.3x) enjoyed by UK, US and Canadian housing associations demonstrates the benefits of long term financing. The provision of a financing product would also encourage state governments to transfer more of their housing stock to CHP's, which would allow for a faster rejuvenation of the existing asset base and the creation of more stock. BCL is examining the option of using a **unit trust type structure** as a way of accommodating the objectives of Federal, State and LGA's, to participate and remain linked to the inherent land value of their current investments. The ability to create such a model will depend on the tax arrangements available to enhance the efficiency of providing non-market housing. BCL believes such a structure could be effective in attracting multiple funding sources and provide a quasi-equity funding source. BCL has also in the past, proposed to NSW Treasury, the creation of an Affordable Housing Bank, as a financial intermediary capable of raising offshore debt, in much the same way as the THFC currently does, however with a stronger capital base. This model was initially directed at the NSW Government but could easily be applied nationally.

The following page has a graphic description of how the affordable housing bank may be structured and operated.

Structure of the proposed Affordable Housing Bank



Comment Options

The Working Groups Paper outlines 4 Options. The following table provides a summary of their usefulness to raising capital in the market.

Model	Summary comment	Support
Option 1: Housing loan/bond aggregators	• The following model is widely used throughout the global financial markets. • It is simple to understand by all parties. • It achieves long term (up to 30 years) tenure and fixed rates reducing refinancing risk. • It is able to be done at scale, it is a tradable product as well through the secondary markets. • The bonds can be rated by ratings agencies which enables them to be purchased by a wide range of institutions. • increasing investor appetite enhances pricing and reduces costs to the CHP.	Yes
Option 2: Housing trusts	• The theory of the housing trust looks to overcome geographic risks but becomes rather cumbersome as the trust role could be at variance of the participating parties. • The risks of creating another large state institution that would kill innovation are highly likely, and does not allow local market flexibility in providing solutions. • Research has proven that entities with between 5,000 to 10,000 dwellings operate most effectively. • It is our belief that an iteration of this could be done more effectively, but using option 1 as part of the funding mix.	No/Yes – possible iteration of the model
Option3: Housing cooperatives	• The problem here is scale and efficiency, the model would prove expensive to administer. • It could however work for specialist housing.	Yes/No
Option4: Impact Investing	• This is a very specialist investing vehicle and expensive to implement. • Recent experience of small scale financing does bring into question the benefits. • However economic and social benefits can be measured which provides template for government to justify using guarantees to support financing using option 1 as the template.	Yes/No

Conclusion and recommendations

BCL recommends to the Working Group that Option 1 should be favoured, with Options 3 & 4 used as overlays. In the case of Option 3 in relation to specialist housing and for Option 4, as a means of supporting Option 1 and the creation of a long term and low cost bond market. BCL would be happy to provide additional detail or comment about these issues to the Working Group if required.