CANADA MORTGAGE AND HOUSING CORPORATION

EQUITY, FUNDING AND FINANCING

Affordable housing solutions need to involve a variety of financial partners. Careful analysis will not only help you to understand the financial help you will need, but will inform potential partners of the risks and rewards to be expected.

All of the planning and preparation work that you have completed will help you now as you begin to pull together the money that will be needed to make your project a reality. There are three key sources of development funds: Equity, Funding and Financing, and each of them has a significant impact on the financial feasibility of your project. This fact sheet will outline how an affordable housing project is financed and some of the key terms used by the financing industry.

Background

Whether you are a non-profit or a for-profit developer, the same financial analysis will be required to determine viability. Unless you have all of the cash required to design and build your project, you will need to demonstrate its feasibility to potential equity, funding, or financing partners.

As your project concept develops, the financial feasibility analysis evolves from rough estimates to detailed calculations. These same calculations will be important to your financial partners and funders, so that they can judge the risk and reward of getting involved in your project. They will be looking for specific figures arrived at using standard formulas, and comparing your proposed project to established benchmarks used in the real estate and financial industries.

Be prepared to provide information on project costs, net operating income (NOI), loan-to-value ratio (LTV), loan-to-cost ratio (LTC) and debt coverage ratio (DCR), among other data. Be sure that you have someone on your development team who is knowledgeable of these terms and can do the calculations for your project.

Project Costs

Project costs are those that are incurred to deliver a completed and occupied housing development. These are described in the "Project Costing and Construction Process" Fact Sheet.

Equity

In most cases, equity may be defined as any material contribution that a sponsoring group controls and that reduces the amount of mortgage financing and/or government subsidies required. Examples of equity include:

- Land and/or buildings that the sponsor group owns or that is being donated by the local government, another non-profit organization or a faith group;
- Cash that the sponsor has saved, or raised in a fundraising campaign;
- Deposits from committed purchasers in the case of a life lease or home ownership option.

Funding

Funding is a general term meaning
a) money to carry out a project, or
b) the way in which money for a project is provided, such as a grant or loan.

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Depending on the source, funding could be applied to either capital costs (those related to the purchase of land, buildings and construction) or operating expenses. Sources of funding may include government programs (housing or otherwise), lottery corporations, charitable foundations, individuals, businesses, and corporations. Most grants or loans of this nature are considered to be non-repayable as long as the terms and conditions set out by the funding organizations are adhered to.

Debt Financing

As a rule, the gap between total project costs and the amount of equity and capital grants invested is made up through debt. There are a number of kinds of debt, but the most common in affordable housing development are construction financing and mortgage financing.

During the construction or renovation phase, short-term financing is used to pay for the work as it progresses. This construction financing is usually provided in lump sums, known as advances, as components of the project are completed. Interest on the outstanding balance is added to the total accumulated loan amount, which becomes repayable on occupancy of the completed building.

Mortgages or permanent financing, also known as 'take out financing' are used for long term financing. Mortgage lenders typically include: banks; trust and life insurance companies; pension funds; and cooperatives. Most affordable housing projects will require a mortgage, in addition to sponsor equity and funding from government or private foundations, to cover all project costs. Mortgage payments are calculated using a formula that takes into account the interest rate, the amount of money borrowed, and the amortization period required to pay off the loan (usually 25 or more years).

Most lenders in Canada are required by law to obtain mortgage loan insurance for any mortgage greater than 80% of the value for multiple unit projects. Mortgage loan insurance protects the lender in case of default on the part of the borrower. CMHC provides mortgage loan insurance on affordable housing projects, which should result in a lower interest rate due to the reduced risk to the lender. CMHC insured financing for affordable housing developments may also enable benefits such as: longer amortization periods of up to 40 years; higher loan-to-value financing; and reduced premiums depending on the level of affordability.

Net Operating Income (NOI)

The difference between gross operating income and operating costs is net operating income (NOI). Essentially this is how much you can afford to pay for your mortgage. Your NOI is an early indicator of your project's viability. The example below uses rough estimates based on market rental industry benchmarks. If you are planning to build housing for low income or special needs residents, consider approaching a housing organization currently operating this type of housing, to find out their actual operating expenses.

If the NOI is less than you have estimated your mortgage payments to be, you will need to look at adjusting one of or a combination of the following: reduce project costs; increase operating revenues; increase the amount of equity being contributed by you and your partners; secure funding from government programs or private foundations; and consider a longer amortization period, which reduces the monthly mortgage payment.

Lending Value

When developing affordable housing projects there may be two methods employed when establishing a "Lending Value". One approach is to base the lending value on project costs, as long as NOI will support the required mortgage payments.

The second approach in determining lending value is typically done by capitalizing the NOI of the proposed affordable housing project using market capitalization rates based on similar income producing properties in the market. Market capitalization rates can vary from 5% to 10%, depending on the type, condition, and location of the property. In this approach, lending value is calculated by dividing the NOI by the market cap rate. Local real estate appraisers and realtors are a good source of information for obtaining appropriate capitalization rates.

Rental income: 20 units @ $700/month	$168,000
Vacancy and bad debt estimate (@ 5%)	$ (8,400)
Effective Gross Income (EGI)	$159,600
Operating costs @ 45% of EGI	$(71,820)
Net operating income (NOI)	**$ 87,780**

Loan-to-Value Ratio (LTV) and Loan-to-Cost Ratio (LTC)

Loan-to-value ratio is a key measure of risk. The loan-to-value ratio is a calculation of the mortgage amount divided by the value of a project.

Loan-to-cost ratio is the mortgage amount divided by the project costs for an affordable rental project. If the LTV or LTC is greater than 80%, the lender will require mortgage loan insurance from CMHC. Generally speaking, the higher the LTV or LTC, the higher the CMHC mortgage loan insurance premium.

Mortgage amount	$2,330,000
Project cost	$2,750,000
Loan-to-cost (LTC) ratio (2,330,000/2,750,000)	85%

Debt Coverage Ratio (DCR)

Debt coverage ratio shows to what extent the net operating income will be adequate to cover the annual mortgage payment. Calculate DCR by dividing the net operating income by the mortgage payment. At a DCR of 1.0, the mortgage payment is exactly equal to the available cash flow; if the result is less than 1.0, the project is not viable as there is not enough income to pay the mortgage.

Suggested Activities

- Develop a financial pro forma in a spreadsheet program that calculates the various factors using the standard formulas. Observe how these factors change by using different project costs, NOI, and cap rates.
- Use CMHC's Affordable Housing Project Viability Assessment Tool for rental projects to test the viability of your project, www.cmhc-schl.gc.ca/en/inpr/afhoce/tore/into/into_002.cfm
- Identify potential partners and funders, how their funding priorities relate to yours, their selection process, and how to contact them.
- Realistically assess the equity that you currently possess and what you would be able to attract from potential partners.
- Check the provincial or territorial government housing department websites to learn about funding programs both relevant and available to your development. (A list of government housing websites is included on the Housing Development Checklist.)
- Contact the CMHC Affordable Housing Centre in your region to discuss your project.
- Line up your construction financing during the pre-development phase so that you are ready to go once all of your planning and building approvals are in place.
- If you will require mortgage loan insurance, make sure that all required documentation is submitted to your lender.
- As your funding commitments are secured, revise your cash flow forecast to ensure you are able to honour all of your debts.
- Your project team including Professional resources such as Cost Consultants will play an integral role in assessing and testing the financial aspects of your project.

Ex. 1 - Project fails to meet the DCR test with less than 1.0		Ex. 2 – Project meets / exceeds a DCR test of 1.0	
NOI	$83,160	NOI	$83,160
Mortgage payment	$127,930	Mortgage payment	$75,600
DCR (83,160/127,930)	0.65	DCR (83,160/75,600)	1.1

Conclusion

The critical test of project viability will determine your ability to pay for the project costs with a combination of equity, funding, and financing. By using a variety of standard formulas accepted by the financial industry, you can assess the viability of your proposed project. If the project isn't viable as you originally envisioned, you will need to make adjustments.

You can improve your NOI and ability to attract more financing by increasing rental income and/or lowering your expenses. Changes to the design of the project could result in reductions to your overall project cost. If you are not already at the maximum amortization period you may want to extend it to reduce the annual debt service costs.

Whatever remedies you develop, as you go forward, your budget must be sound and not show a deficit. It must be financially viable to make a strong business case and attract development partners.

Resources

Philanthropic Support for Affordable Housing, CMHC Research Highlight Socio Economic Series #67: www.cmhc.ca

Canadian Housing and Renewal Association Affordable Housing: Finance, a comprehensive list of funding programs for housing in each province and territory: www.chra-achru.ca/english/View.asp?x=662&mp=529

Financing and Tenure on CMHC Website: www.cmhc-schl.gc.ca/en/inpr/afhoce/tore/afhoid/fite/index.cfm

Building a Nation: Innovations in Financing Affordable Housing, Summary Report on Western Regional Symposium, Saskatoon, SK, November 2004: www.chra-achru.ca/CMFiles/Building_a_Nation_Innovations_in_Financing_Affordable_Housing_Saskatoon_Regional_Meeting_Report17KBK-2102005-8254.pdf

Ontario Non-Profit Housing Association (ONPHA): Securing Mortgage Financing For Affordable Housing - A Guide For Non-Profit Providers: www.onpha.on.ca/affordable_housing_initiatives/funding/

What's a Cap Rate Anyhow? By Ozzie Jurock: www2.jurock.com/commercial/tips/caprates.asp