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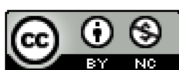

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Acronyms and abbreviations used in this report

AASB	Australian Accounting Standards Board
AHURI	Australian Housing and Urban Research Institute Limited
AHV	Aboriginal Housing Victoria
AMP	Asset Management Plan
API	Australian Property Institute
BHF	Better Housing Futures (Tasmania)
BPSC	Better Places, Stronger Communities (South Australia)
CHC	Commonwealth Housing Commission
CHP	Community Housing Provider
CPV	Certified Practicing Valuer
CRA	Commonwealth Rent Assistance
CSIRO	Commonwealth Scientific and Industrial Research Organisation
CSO	Community Service Obligation
DHHS	Department of Health and Human Services (Victoria and Tasmania)
DTF	Department of Treasury and Finance (Victoria)
EBIT	Earnings Before Interest and Tax
FaCS	Department of Family and Community Services (NSW)
FR	Financial Reporting
FRV	Financial Reporting Valuation
GST	Goods and Services Tax
HBU	Highest and Best Use
ICR	Interest Cover Ratio
IFRS	International Financial Reporting Standards
IP	Intellectual Property
IPWEA	Institute of Public Works Engineering Australasia
IVS	International Valuation Standards
LAHC	Land and Housing Corporation (NSW)
LVR	Loan to Value Ratio
NAHA	National Affordable Housing Agreement

NAMS	National Asset Management Strategy committee
NFP	Not-for-profit
NRAS	National Rental Affordability Scheme
NSW	New South Wales
PAS	Property Assessment Survey (NSW)
PIR	Property Inspection Report
PSI	Property Standards Index (Queensland)
RMA	Residential Management Agreement (South Australia)
RSL	Registered Social Landlord
SDA	Sales and Development Agreement
SHA	State Housing Agency/Authority
VGV	Valuer-General Victoria

Executive summary

In recent times, the transfer of public housing from State Housing Authorities (SHAs) to Community Housing Providers (CHPs) known as 'stock transfer' or 'property transfer' has involved either the transfer of management rights through a lease (responsibility to manage tenancies, repair and maintain assets), or transfer of the asset itself (title is transferred). This has become a preferred policy tool of state and federal housing authorities as a means of better using scarce public resources, building capacity in the Community Housing Sector and increasing the supply of affordable housing.

Of all housing transfers in Australia up until 2013, 28 per cent (about 6,000 dwellings) were title transfers and 72 per cent (about 15,000) were management transfers (Pawson, Milligan et al. 2013). Management transfers have now occurred in Victoria, Western Australia, South Australia, Tasmania and New South Wales (NSW). The current transfer of housing in NSW[1] (18,000 properties) is being done through long-term leases. Tasmania initially only transferred vacant land title and is only now undertaking title transfer of 500 properties that are presently under the management of CHPs.

Both types of property transfer entail financial consequences for both public housing authorities and CHPs.

Property transfer offers the prospect of a number of potential benefits, including raising the capacity of CHPs to borrow against the title of assets or against the financial cash flows associated with rental revenue. It also might facilitate equity finance for CHPs operating at sufficient scale. This may assist further expansion of the sector, to meet the existing undersupply of affordable housing for low-income households.

Though the Federal Treasurer stated in his budget speech that States and Territories will also be encouraged to transfer stock to the community housing sector". The policy context for property transfers is changing rapidly. The 2017 Federal Budget saw a number of measures to enable growth in the supply of affordable housing. These may signal a move away from growth of the affordable housing sector via property transfers alone. As well, a recent Productivity Commission report recommended reform of the subsidy flows in affordable housing to allow eligible low-income tenants to receive Commonwealth Rent Assistance (CRA) regardless of who their landlord is—state government, community housing, or private. If implemented, this would remove some of the financial advantages CHPs currently have relative to public housing agencies, potentially undermining the impetus to transfer properties. Moreover, to support the effectiveness of the new Budget measures a subsidy of some description will also be required to bridge the yield gap from sub market rates available from affordable housing.

This research explores the technicalities of property transfer transactions in the Australian context. In particular, this paper explores legal issues, the valuation of assets, the condition of the assets involved, and the potential of new owners to use the assets efficiently.

The findings from this research will assist in identifying principles critical to best practice.

The research focused on four key questions:

1 What are the legal issues in property transfers?

2 How are valuation standards and methodologies applicable within property transfers?

3 What are the optimal capital management practices for social housing stakeholders?

[1] Currently under tender

4 What are the processes and benefits of building condition assessment (planned maintenance) schemes?

In addressing these questions, the research team reviewed previous research on property transfers, conducted interviews with government officials involved in property transfers, and discussed the findings at two meetings of industry panel stakeholders.

Legal issues in property transfers

Management transfer

Some of the legal issues that may encumber the value of assets managed (for management transfer) include:

- whether leases are transferred to CHP control
- what costs CHPs must bear in relation to tenancy management
- what costs CHPs must bear in relation to repairs, maintenance and expectations of future housing supply
- whether tenants have rights to choose their landlord
- the length of the lease transferred to CHPs and the rights or encumbrances attached to that lease
- whether the arrangements prove to be overly complex.

This research finds that the transfer of management rights to CHPs allows for some independence for the CHP. The use of sub-leases effectively enables CHPs to receive rent and CRA as revenue sources. However, these arrangements come with detailed and, at times, onerous and complex obligations. CHPs are responsible not only for ongoing maintenance issues, rates and charges, but also for retrospective maintenance and repairs. Two states had arrangements whereby tenants could choose whether they were managed by a CHP or public housing and CHPs were able to provide incentives to tenants to change their landlord.

Asset transfer

Only three jurisdictions (Tasmania, NSW and Victoria) have embarked on asset transfer. In these cases, some of the issues that encumber the value of assets managed include:

- condition of the assets on transfer (and expected repairs required to bring up to standard)
- whether the state retains an interest in properties that are sold (e.g. those dwellings sold as part of recycling ageing stock)
- the length of the lease and conditions attached to the lease.

The initial asset transfers in NSW were new houses and not subject to issues of older stock that might need repairs or replacement. In recent asset transfers in NSW the assets have been leased to CHPs for 20 years—providing an effective asset transfer and allowing the CHPs to borrow against the revenue flows that relate to that leasehold period. Although, title remains with the state, the 20 year period is beneficial as it provides long term certainty. The state has retained an interest in dwellings sold and requires that the state be informed ahead of any potential default. In Victoria, the Director of Housing retains an interest and approval must be sought for sales of assets although approval cannot be unreasonably withheld. These arrangements do potentially reduce the freedom of CHPs to dispose of the asset and potentially

affects their borrowing capacity. The Tasmanian title transfer provided greater freedoms but was limited to land transfers.

Valuation standards and methodologies for social housing

The main forms of valuation in Australia are:

- *Market comparison*—also known as the sales comparison approach, this is most relevant when seeking to substitute for similar residential properties. However, this is difficult as it rarely occurs with social housing. Use of comparisons with the private market would need to take into account differences in condition in addition to whether there is a Directors Interest held in the property by the SHA.
- *Income approach*—anticipation of future income benefits from property. In the case of social housing, this needs to take account of the differences between social and market housing as well as costs associated with maintenance, including deferred maintenance costs.
- *Cost approach*—looks at replacement cost of the asset and may be most appropriate for public good assets where the asset is very specialised or there are very limited comparable sales.

The adopted valuation methods are set out through standards and procedures under the International Valuation Standards (2013) and then transferred into practice through the Australian and New Zealand Valuation Standards (2013). These standards are complemented by the *Valuation of Land Act*, which is state specific, and determines the valuation process for government-owned assets.

The value placed on the asset is determined by the purpose of the valuation. The most appropriate method when calculating market value is going to be determined by the highest and best use (HBU) of the property and whether the purpose of the valuation is for financial reporting or transfer at market value. In the case of asset transfer—involving transfer of assets from one organisation to another—a market value is required. This means most jurisdictions choose the market comparison method. The Victorian Department of Land Water and Planning (DELWP 2015) and NSW Treasury (2014) have both identified the market comparison method as the most appropriate valuation method for public housing. This is also the method approved and used by the Valuer-General in those two states.

There is no current consensus on the type of value that must be reported for assets held by CHPs in Australia in a financial year. This reflects differences between states about valuing assets (Productivity Commission 2012). This is made more difficult by the fact that values from stock transfers to CHPs have had no comparable valuation mechanism. Transfers within social housing have been limited reflecting the lack of a market for such assets. There are similar properties to public housing stock that are transacted through the private market and can be used as benchmarks.

Not considered in market comparison valuation are the outcomes, such as community benefit, sought/expected by governments. These outcomes include:

- increasing the supply of social housing
- increasing services and operational efficiencies
- empowering tenants, leading to place management and community renewal
- ensuring good quality housing—well maintained and in good condition and in an appropriate setting and location.

For the CHP to achieve these outcomes, the investment must be financially viable.

The valuation of the asset is determined by the sale of similar properties, however the value to the CHPs may be encumbered by conditions placed on the provider such as:

- requirement to provide ongoing affordability and security housing to tenants
- restrictions on capacity to sell assets to third parties at market value.

There may also be risks on valuation related to actions of government such as political change, changes in policy or a change in the value of CRA which would significantly reduce CHPs' income and affect meeting debt repayments.

Optimal capital management practices

The capital structure for businesses, including CHPs, can consist of both debt and equity. Whereas equity is the capital contribution from the CHP, debt capital is sourced from financial institutions.

Due to risks associated with the debt lending, financial institutions generally require some form of collateral as security to defray the debt in the event of default by the borrowing entity, in this case the CHPs. Financial institutions generally demand real property for use as collateral because it is the most secure asset. Therefore, CHPs can secure debt capital against assets under their management or ownership, (depending on the rights of control of the asset arising from different types of transfer across the states) and with approval from the entity transferring the stock to the CHPs. In lieu of using assets as collateral for debt funding, CHPs have the option of borrowing against the cash flows that are generated from their operations. In this case, the CHPs do not need to use the portfolio (stock) as security against the debt but need to demonstrate the viability of their business to generate enough cash flow to service the debt payments.

Processes and benefits of building condition assessment

There are a number of problems reported regarding condition assessment and maintenance in relation to property transfers:

- lack of consistency in assessment tools including a national set of standards between states and territories around asset condition
- lack of reliable data on assets—CHPs are given data on condition of assets during a tender process, but this may be out-of-date and they have no capacity to make independent assessments
- lack of transparency around maintenance.

In property transfers to date, some of the risks associated with the issues above were reduced by a number of steps in the transfer process:

- In cases of management transfers, responsibility for structural repairs usually remained the responsibility of the SHA.
- A two-staged transfer (as has occurred in Victoria and is occurring in Tasmania), in which the CHP takes over maintenance responsibilities before the asset is transferred, has enabled CHPs to first become familiar with the assets and ensure they are better able to understand their value.

- Where asset (title) transfers have taken place, the assets have been in good condition. For example, in NSW many of the dwellings transferred were new properties developed through the Nation Building Economic Stimulus package, so there were fewer complications associated with ageing stock.
- In cases where older assets were transferred, some money was provided by the SHA to bring the stock up to a certain standard. In Tasmania, a requirement was in the agreement that there be financial investment in maintenance and improvement of older properties reflecting existing deferred maintenance liabilities.

Further improvements in processes are suggested as part of a due diligence process (perhaps done at the time of tender) and then monitored subsequently at milestones in any agreement between a SHA and a CHP. Suggested improvements include:

- *Use consistent tools for assessment of condition of stock*. The National Assets Management Strategy (NAMS) from the Institute of Public Works Engineering Australasia (IPWEA) provides a condition assessment methodology and asset planning processes through their best practice guidelines, as well as training and certification. There is also an international best practice standard and guide (ISO55000) that could be consulted. These could inform the basis of common methodology across jurisdictions.
- *Adopt common national standards for condition of stock*. It may be possible to learn from the example of the UK where a common set of Decent Housing Standards for their social housing sector was introduced in the early 2000s.
- *Keep good data on assets*. At the time of transfer and afterwards, good information-keeping supports sound asset management practices such as forecasting maintenance requirements, backlog maintenance and non-compliance.
- *Use up-to-date IT software, training, certification and audit processes*. For example, some larger CHPs use their own asset condition assessment software and condition ratings in order to attain greater consistency across states.

Conclusions

The development of property transfer methodologies over the relatively short history of this practice in Australia, suggests that both government and CHPs are learning and negotiating improved processes.

Property transfers have the potential to increase social and affordable housing supply by raising the capacity of CHPs to borrow against the title of assets or against the cash flows associated with long-term rental revenues. This research finds, however, that for these benefits to be fully realised greater transparency in the areas of contract technicalities, for example, property condition assessment, is required.

1 Introduction

In 2017, approximately 400,000 households live in social housing. Government entities manage four out of five social housing properties; the remainder—over 80,000 dwellings—are managed by not-for-profit community housing providers (CHPs) (Productivity Commission 2017). Most housing in the sector (around 80% is managed by the 30 providers who are PowerHousing members (NSW FACS, 2017). An estimated minimum of 200,000 additional affordable housing dwellings will be required over the next 20 years (Milligan, Pawson et al. 2017).

In a current Inquiry, the Productivity Commission has reviewed human services and identified social housing as one area where outcomes might be improved through greater competition, contestability and informed user choice. The Productivity Commission's Interim Report recommends a single model of financial assistance for eligible households based on their circumstances, rather than whether they rent social or private housing. Specifically, this would include:

- CRA being available to public housing tenants with a move to market rents in social housing
- a 15 per cent increase in CRA and annual indexation to rent increases nationally
- an additional payment for tenants with a demonstrated need for additional assistance
- choice-based lettings for social housing
- access to tenancy support services whether in social housing or private rental
- separate commissioning of tenancy support from tenancy management
- focusing social housing on those not well placed to enter the private rental market.

(Productivity Commission 2017, Reforms to Human Services)

If ultimately implemented such reforms would remove a financial difference that CHPs currently provide and would likely slow down the impetus behind property transfers and the development of an at-scale, multi-provider, competitive affordable housing industry.

Stock transfers from State Housing Authorities (SHAs) to CHPs were initially motivated by the financial unsustainability of public housing provision and by the National Affordable Housing Agreement (NAHA). Tenants of CHPs are, however, entitled to receive the Commonwealth Rent Assistance (CRA), which assists CHPs to charge rents that can help to meet financial viability. In 2009, Housing Ministers agreed to the target of increasing the community housing sector to constitute 'up to 35 per cent of all social housing by 2014'. By 2017, Tasmania has exceeded this target (46%) and NSW has committed to attaining this figure.

A key issue for CHPs is whether they are able to attract financing to enable expansion. At present, the financing capacity of CHPs is limited, with most having low loan-to-valuation ratios. Stock transfer offers the prospect that CHPs might use asset title or financial net revenue flows to invest more money in new supply from institutional sources. There is presently appetite from investors for investing in the sector based on higher leverage and long-term tenures (PWC 2015: 5). Federal Budget 2017 initiatives will help realise this investor appetite, particularly:

- the establishment of a National Housing Finance and Investment Corporation to operate an affordable housing bond aggregator
- an increase in the capital gains tax discount from 50–60 per cent for individuals and Managed Investment Trusts to invest in affordable housing
- a new NAHA with state and territory governments to increase the supply of new homes.

Such reforms are likely to focus the growth trajectory of the affordable housing industry on new supply and to a lesser extent property transfers.

Property transfers—involving either transfer of stock for management by CHPs or its title—have been undertaken in a number of jurisdictions, including NSW, Western Australia (WA), Tasmania, South Australia and Victoria:

- NSW has the largest portfolio (with around 144,000 social housing properties) and at the time of completing this report, had released a tender for the management of 18,000 properties to be transferred to CHPs—while the title is not officially transferred, its long-term nature (20 years) effectively makes it an asset transfer.

In WA 1,721 assets were transferred between 2010 and 2013-14, a further 211 were transferred to the community housing sector in 2015-16 (Housing Authority, 2016a)

- Tasmania has recently transferred leases for 4,000 properties, and is looking to convert 500 of these properties into a transfer of title.
- South Australia has transferred approximately 1,000 properties (on a three-year lease) with a further 4,000 underway (on a 20-year lease). The tender process was undertaken in two stages. The first stage determined the successful providers who moved on to the second stage where extensive consultation between Renewal SA and CHPs was undertaken.
- Victoria has transferred smaller lease numbers, but has also recently transferred approximately 1,500 titles to Aboriginal Housing Victoria, and has announced in February 2017 a proposal to transfer management of an additional 4,000 properties to CHPs and a further 100 properties with title transfer.

1.1 Project aims and research questions

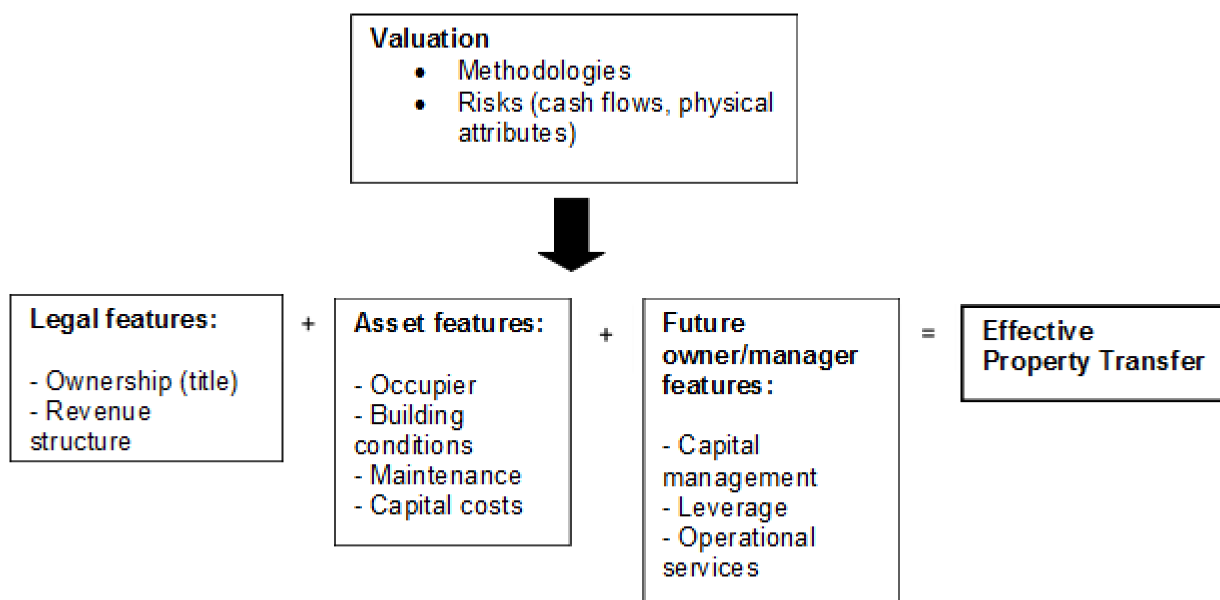
The overarching purpose of this investigation is to inform stakeholders of the key features of the property transfer mechanisms that impact on the ability to deliver community benefit. Property transfers enable the state to leverage the existing stock of social housing to obtain wider community benefits such as:

- growth in overall supply of social housing
- tenants enjoying well maintained property in good condition
- tenants enjoying an appropriate physical setting
- tenants enjoying appropriate residential locations.

The Australian public housing transfers approach is based partly on success in international contexts. AHURI research into stock transfers in the UK argues that success is more than value for money (e.g. value of stock and improved maintenance, which are common motives for stock transfer) and identifies success in four categories: assets, human capital, strategy (board and business plan), and community and wider impact (Maclennan and Maio 2017).

This research, however, is focused on the methodologies of property transfer: legal structure, valuation, building condition assessment and capital management factors. Figure 1 below shows the principal elements that can inform the decision process by which properties are transferred.

Figure 1: Property transfer structure



In addressing these features, we will base our investigation on four research questions:

1. What are the legal issues in property transfers?
2. How are valuation standards and methodologies applicable within property transfers?
3. What are the optimal capital management practices for social housing stakeholders?
4. What are the processes and benefits of building condition assessment (planned maintenance) schemes?

Various transfer options—including both management and asset transfers—were explored as part of this project.

1.2 Research scope and methodology

This Inquiry involved primary and secondary research including:

- an expert review, synthesising previous secondary research, including what was known about property transfers overseas and locally—a summary of this evidence including the key findings around stock transfer overseas is in Appendix 1
- interviews with key government officials from four Australian states: NSW, Tasmania, Victoria, and South Australia—each state has been recently involved in the transfer of properties, either through leasing arrangements or transfer of title.

The research findings were presented to an Inquiry panel with members from CHPs and government stakeholders:

- The first Inquiry panel meeting was held in Melbourne on 28 October 2016.
- The second Inquiry panel meeting was held in Melbourne on 23 February 2017.

This Final Report draws together findings and takes into account the comments from the Inquiry Panel.

1.3 Report structure

The remainder of this report is structured as follows:

- Chapter 2: describes the legal issues involved for CHPs and governments seeking to transfer stock to CHPs.
- Chapter 3: describes the valuation methodologies available to value stock in the context of asset transfers.
- Chapter 4: presents an understanding of the issues presently facing CHPs and governments in capital management, and what could be done to optimise the practices around capital management.
- Chapter 5: describes present processes in assessing building conditions and its benefits for parties in property transfer processes.
- Chapter 6 concludes the report and provides a summary of implications for both policy-makers and CHPs.

2 Legal issues in property transfers

2.1 Introduction

States and territories across Australia have different processes to deal with the transfer of title of government land and properties for the use of social and affordable housing. Broadly speaking, there are two categories of transfer occurring in Australia:

- transfer of only management rights of government-owned housing and related assets
- transfer of the land or development rights, and this might be through long leases or development deeds.

In some cases (e.g. South Australia and Tasmania), title transfer has been a secondary process after initial management transfer. Some states have also done pilot transfers as a way of testing the process. Across Australia absolute freehold title transfer is uncommon, with 28 per cent of transfers thus far in this category. Instead, state housing agencies have preferred to retain an interest on the title of their properties on behalf of their respective Directors of Housing.

There is also diversity in the way the transfers are legally structured, and this has implications for the governance, finance, accounting and valuation for these properties and parcels of land, impacting in turn on how CHPs operate in the various states and territories across Australia.

The accounting treatment of transfers by long-term contract records the assets concerned as 'disposals' on the public accounts. Such transfers via long-term contracts, being some 10–20 years in duration, are anticipated by housing agencies to provide CHPs, with assured revenue flows, to be able to address maintenance backlogs, add to community development and modestly expand affordable housing supply.

This chapter seeks to understand the technical legal processes involved in transfer processes based on interviews with government officers. It canvasses the different models of transfer on offer in different states, then their legal requirements and how they may impact on the ability of CHPs to secure debt capital under both management and title transfers.

The discussion here draws on data from Tasmania, Victoria, South Australia and NSW, as reflected in interviews with housing agency officers from those states, as well as from the reading of Tasmanian and NSW community housing provider contracts of transfer/asset management.[2]

2.2 Models of transfer

Management transfer

A common model used by Australian states has been the transfer to CHPs of only the management rights of social housing properties. Management transfers have occurred in Victoria, South Australia, Tasmania and NSW.

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[2] This research draws upon AHURI evidence and particularly upon recent AHURI reports from the AHURI Inquiry into Affordable Housing Industry Capacity: Pawson, Martin, et al.. (2016) *Recent housing transfer experience in Australia: implications for affordable housing industry development*; Milligan, Pawson et al. , *Developing the scale and capacity of Australia's affordable housing industry,* and Maclennan and Miao (2017) *Transformative transfers: growing capacities in UK social housing.*

The terms of management transfers are set out in contractual agreements between the Housing Agency and the CHP. These agreements allow the former to retain title, and therefore ultimate control, over the parcel of land.

Most arrangements involve concurrent leases between tenants and both the SHA and CHP. This allows rents to be paid to the CHP managing the property while the title (and therefore lease agreement with the tenant) remain with the Housing Authority. Tasmania has had agreements, which are structured as agency agreements rather than leases in relation to transferred properties. The agreement is subject to existing residential tenancy agreements and, when these terminate, the agency agreement provides for the Tasmanian Government and the CHP to enter into a concurrent lease for that property, allowing the tenants to become eligible for Commonwealth Rent Assistance (Pawson, Martin et al. 2016).

2.2.1 Asset transfer

Clear title transfer of a parcel of land to a CHP provides the highest form of property interest. This allows CHPs to deal with the land in the manner they choose. By contrast, asset transfer with a housing agency retaining an interest or some other encumbrance on title restricts a CHP's freedom to deal with the land. Complete transfer of titles are uncommon, however, some long-term lease arrangements like those in NSW approach this.

Interest retained over assets—New South Wales

NSW holds the largest volume of public housing with around 144,000 social housing properties. At the time of completing this report, NSW has just released a tender for the management of 18,000 properties to be transferred to CHPs on a 20-year lease arrangement.

The intent of this accounting treatment of transfers by long-term contract permits the assets to be recorded as ‘disposals’ on the public accounts.

A key aspect of this arrangement is that the title to public housing stock is owned by a corporation. The Land and Housing Corporation (NSW) (LAHC)[3] is an agency of the Department of Family and Community Services (NSW) (FaCS), a legal entity that owns the stock in NSW, effectively being the property asset arm for FaCS.

The LAHC has as part of its mandate to:

- support the growth of not-for-profit (NFP) community housing providers capable of increasing the supply of affordable rental accommodation for people in need in NSW
- enable community housing providers to strategically manage assets to better meet future housing demand and the changing needs of residents
- provide a secure asset base for community housing providers to leverage additional finance for investment in social and affordable housing.

The terms of the arrangement allow the LAHC to retain an interest in the properties concerned. For example, the contracts specify that the LAHC may at any time, in writing, require providers to grant and execute a charge or mortgage against any relevant property to secure the payment of all moneys owing or to become owing under the Community Housing Agreement. Also, in the event of termination of the agreement, the CHP must repay LAHC any or all of the funding together with interest earned on the funding.

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[3] A Housing Agency within the meaning of the *Community Housing Providers (Adoption of National Law) Act 2012* (NSW) and the National Law.

Two-stage property transfers have developed in a number of jurisdictions where the first stage is a management transfer and the second involves the transfer of titles.

In South Australia, through Renewal SA, approximately 1,000 leases were transferred in 2015, with a further 4,000 being transferred in 2017. The tender process was undertaken in two stages. The first stage determined the successful providers who then moved on to the second stage where extensive consultation between Renewal SA and CHPs was undertaken.

In undertaking management transfer of properties, Tasmania initially transferred vacant land (with rights to develop it). However, it is now undertaking title transfer of 500 properties that are presently under management by CHPs. This will be managed via a tender process with take up coming from either tier one or tier two registered housing providers, and providers having to address deferred maintenance issues.

Victoria has issued contracts that transfer title to particular CHPs. There has been a recent process where title has vested to Aboriginal Housing Victoria.

2.3 Legal requirements for management transfer

2.3.1 Arrangements to ensure leases are transferred to CHP control using concurrent leases

In states using management transfers, responsibilities for maintenance and repair are transferred to the CHPs. Typically this means the structural features of the property remain the responsibility of the owner (the state) but lessees (CHPs) do ongoing maintenance or contract others to do it. The leasehold arrangements would not change for the residential tenant (since the title is not transferred).

In South Australia, the tenant has a lease with the Housing Trust—which is the South Australian Public Housing Authority. The state government has developed a concurrent lease arrangement where the Public Housing Authority concurrently awards lease management to the not-for-profit CHPs, thereby the tenant retains a concurrent lease.[4] With the not-for-profit CHP manager, the tenant becomes eligible for CRA (providing all other eligibility requirements are met) and an automatic payment from Centrelink can be made to the tenant. Such assured income allows a CHP to better plan for future maintenance and development. South Australia was the first state to adopt this concurrent lease model which other states have now adopted.

In the NSW system, the initial arrangement was for the provider to become an intermediate landlord and the lease would be treated as a private lease. However, NSW has now adopted the concurrent lease arrangement.

Important in this process is that the providers get access to revenues from leasehold arrangements and these revenues more than compensate for outgoings incurred. In Tasmania, management transfers involved CHPs taking on property outgoings in exchange for rental revenues, receipt of CRA and the proceeds of sale of some properties—the latter was to compensate for the loss of revenue from sale of properties and to incentivise increased supply.

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[4] Pawson, Martin et al. (2016: 29) note that the way the South Australian 'agreements are structured, from the outset, to grant the CHP a lease for each of the transferred properties, they run concurrently with each tenant's existing residential tenancy agreement. This arrangement, known as a 'concurrent lease', is a straightforward (if apparently little-known in Australian social housing) application of principles from the common law of leases; no special legislation is required to enable it. The result is that the CHPs receive a lease of the SAHT's interest, as lessor, in each tenancy, and so become the landlord—while the tenants become eligible for CRA—for the term of the concurrent lease.'

For the sake of management efficiency, entire suburbs of public housing were transferred and larger national CHPs (able to cope with the larger tenancy load) were selected.

2.3.2 Arrangements for tenancy choice

A critical issue for CHPs is whether sufficient numbers of leases are transferred over to their control. This is important to build the capacity and scale of CHPs.

A number of states (Tasmania, South Australia and NSW) provided a process where existing tenants are asked whether they wish to stay with the existing state-owned stock (public housing) or move to accommodation managed or owned by registered housing providers. NSW interviewees observed that they write to tenants to let them know which properties have been selected under the property transfer program.

In both Victoria and Tasmania, tenants were given a choice over signing on with a CHP. In Tasmania's case, the take up has been high relative to modelled estimates and so this has increased access to CRA, reflecting good tenant consultation processes and the use of incentives.

The interviews for this study highlight that for Victoria this shifting of tenancies from the Director of Housing to CHPs is highly complex, and tenants cannot be forced to change landlords. In the past, rent setting rules, rebates etc. were identical for the Director and the CHP. This is no longer the situation in all states, hence creating a new situation where there are different legal models and rules within the states themselves for rents and rebates and so forth.

It was observed that under earlier, property transfer programs, tenants were given a choice of either community housing management or to stay with public housing. If they choose to stay in public housing, they could be relocated. This has now changed as tenants hold concurrent leases so that CRA funds can be claimed. Pawson, Martin et al. (2016: 43) report on CHP sign-up incentives including $150 grocery vouchers and $10-a-week tenant 'bonuses'.

South Australia, Victoria and Tasmania, undertook extensive consultation with tenants prior to the transfer of the lease, which they advise, allowed for a smoother transition from the SHA to the CHP for the tenants. In South Australia an SHA employee was provided for a 12 month transition period to sit in the CHP local office to support tenants with the transition. It was felt that when tenants are kept fully informed with the facts there is less fear of change.

2.3.3 Agreements over obligations of CHPs to repair, maintain and develop further housing

Under the conditions of most transfers, CHPs are responsible for ongoing repairs, maintenance, rates and charges. Repair and maintenance works must accord with state legislative requirements and the Building Code of Australia. In relation to structural repairs, liability usually lies with the government but problems can arise if there are additional or unexpected repairs after the initial repairs were put in place, which may lead to grey areas of responsibility, and GST implications.

A similar division of responsibilities occurs in relation to insurance. In some situations, the Director self-insures and is responsible for fire services. In relation to insurance, in NSW for instance, the CHP takes responsibility for public liability insurance, workers compensation insurance, loss or damage insurance to its property portfolio, and landlord insurance etc.

Independent contractors are often used for upgrading properties. Separate maintenance contracts are put in place for these works.

In NSW, a critical condition imposed is that the housing is transferred at an adequate standard ('clean, safe and habitable') and then maintained. The standard of repair is governed by the nature of the repair required under the *Residential Tenancy Act*. The CHPs have access to the

current condition reports for the sub-tenants and an amount could be negotiated to do repairs at time of transfer. The costs of repair are to be covered by rent, however no other expectations (e.g. increasing supply of housing) are imposed on providers.

From the interviews it was observed that some properties are up to 65 years old and that there is a real problem with the condition of these properties being more suitable for knock down or sale. This is a particular problem for South Australia, which has a large amount of older stock. From the interviews it was noted that providers do not have to return a property back in a better condition than it was at the time when the lease was granted. From the NSW interviews, it was noted that some providers are coming back to the government saying that properties have reached their economic lifecycle and need to be either traded or funding must be sought for redevelopment. Some provider contracts also allow for more housing to be built on site or for trading for another site and this is based on the leveraging of existing land and properties. Some providers are mandated in their agreements to make use of leveraging to ensure an income stream to cover repairs, maintenance and more social/affordable housing stock.

Many of the contracts with providers codify requirements on CHPs for provision of asset condition data. In Tasmania, for instance, provider contracts require the provision of asset condition data within three months of the contract, and provide property inspection reports (PIRs) throughout the term of the lease at least every three years. They also specify programs of maintenance and repair—both 'responsive maintenance' and 'scheduled and periodic maintenance', which the provider must undertake in accordance with the requirements under the state *Residential Tenancy Act*. Responsive maintenance includes a range of actions, including work to essential services, with the intention of protecting the health and safety of tenants. Data on scheduled and periodic maintenance and budgets should be shared with the department and written consent is also required for major works.

2.3.4 Ensuring that long-term leases as part of management transfers satisfy requirements of banks to lend to CHPs

A critical matter is whether asset transfers facilitate lending to CHPs, since this is an important rationale for transfer. Management transfer may be sufficient to enable such lending rather than title transfer. Pawson, Martin et al. (2016: 47) note that through CHPs gaining long-lease acquisitions of former public housing, they are put into a better position for cash flow-based lending. Through CRA enhanced rent revenues, transfers of public housing to CHPs offers the potential to help clear maintenance backlogs and to improve community development and modest affordable housing stock growth.

In relation to both management and asset transfers, a critical dimension in gaining access to finance is income streams, and so it is vital that tenants of transferred properties are able to access CRA. In this sense, it is important that any legal arrangement ensures that:

- property title is effectively transferred to a NFP provider (and therefore the underlying leases are considered to be private not public leases, thereby qualifying for CRA)

or

- the provider is in receipt of CRA because the lease is considered to effectively be one with a private provider. In South Australia and NSW, the system of concurrent leases with state Housing Agencies and CHP are structured so that CHPs can access CRA.

2.3.5 Ensuring legal arrangements are not overly complex

Pawson, Martin et al. (2016: 36) note that the contracts they consulted from Tasmania (BHF—Better Housing Futures) and the South Australia (BPSC—Better Places, Stronger Communities), are long and complex documents. The contractual documentation for the BHF

transfers consists of a Residential Management Agreement (RMA), a Sales and Development Agreement (SDA), and leases with tenants who have signed up with the CHP. The RMA sets out the CHP's obligations in relation to property and tenancy management, and allows for grants of leases. The SDA is concerned with the transfer of title to any vacant land and commits the CHP to new development. The BPSC agreement is effectively a deed of management, which grants the concurrent leases and lays out the transfer terms.

The arrangements are typically written to ensure overriding control by state authorities. The agreements make provision for termination on default, and without fault, with some obligations on the CHPs to prepare disengagement plans where termination is pending. Compensation on termination, in the RMA agreement, is at the Minister's discretion.

While the transfer arrangements may come into effect, they may not achieve all they set out to if they are onerous or complex. The complexity and extensive terms and conditions in management transfer contracts might provide for onerous risks on CHPs. Further, long-lease contracts, when too tightly drawn by governments, might stymie innovation and creativity in portfolio management.

2.4 Legal requirements for asset transfer

There is limited experience in Australia in transfer of assets and the legal requirements with three jurisdictions (Tasmania, NSW and Victoria) having undertaken asset transfer with management transfer dominating the approach and specific contextual factors determining legal processes. The initial asset transfers in NSW were assisted by the stock being new. The Tasmanian title transfer was limited to land transfers. The Victorian transfers were undertaken in the context of the development of Aboriginal Housing Victoria. Given this specific objective, the transfers were staged and began with management contracts which incorporated responsibility for maintenance, insurance and outgoings making the title transfer much more straightforward.

2.4.1 Legal arrangements to ensure asset transfers satisfy requirements of banks to lend to CHPs

Although no title changes hands, asset transfers in NSW should enable borrowing by CHPs. From the interviews with officials, it is understood that many properties have a loan-to-value ratio of around about 25–35 per cent and providers can mortgage these properties to obtain finance for maintenance and further development or redevelopment. This provides significant potential to borrow against properties that did not exist before. Under an earlier scheme, there was a debt equity arrangement in NSW because LAHC did not have the statutory power to borrow money, so it could not mortgage properties.

2.4.2 Codifying interests in sale of properties

A key encumbrance in NSW is that CHPs must agree that the Housing Agency directly retain an interest on title to each vested property or any land or properties purchased wholly or in part using the net sale proceeds of a vested property. This affects the raising of finance and control over properties, as CHPs who wish to gain further finance must firstly obtain consent from the Housing Authority. This also applies if they wish to trade or redevelop the property. The 'ownership' of such properties is different from that of private property title transfer arrangements, as noted in the various state *Transfer of Land Acts*.

In Victoria, the *Housing Act* dictates the Director's interest and the CHP cannot trade without the Director's approval. In both Victoria and NSW the Housing Agency cannot unreasonably withhold consent to the trading of properties.

In NSW, properties can vest to the CHP subject to the provider meeting and continuing to meet certain obligations under statute, policies, guidelines and contractual agreements with the

Housing Agency. Such vested properties must be used to provide social housing or other purposes approved by the Housing Agency. There are strict guidelines in NSW regarding the sale proceeds of a vested property, which must only be used to acquire land or property for the provision of further social housing or ancillary purposes.

2.4.3 Codifying arrangements for cases of default

For NSW LAHC properties, there is a dealing in vested asset process, whereby a caveat is placed on the title by the Housing Agency. A small number of properties have a mortgage on the title, but the interest that the Housing Agency holds is superior over any mortgage. Consequently, any default in payment means that the Housing Agency is notified in the first instance by the mortgagee. By the same token, the Housing Agency cannot unreasonably withhold consent to the trading of these assets by the CHP.

2.5 Summary

Housing agencies are opting for transfers to CHPs via management agreements and limited title transfer arrangements and few are transferring title in entirety. This more guarded approach to transfers is relevant to CHPs being able to raise finance on the assets.

As part of a risk management approach, the agencies retain an interest on titles and many transfer contracts have strict termination clauses that can see CHPs losing absolute control over parcel properties. This detracts from the control CHPs may have to raise finance though it may still allow for borrowing. Such encumbrances on title, including mandatory caveats placed on titles by housing authorities, could affect the valuation which may dissuade or delay finance companies from lending to CHPs even though they may be deemed a necessary precaution given the potential risks to tenants in cases of provider default.

CHPs, via concurrent contracts with housing authorities, are able to rely on accessing Commonwealth Rent Assistance (CRA) for assured funding and this will assist providers to convince banks to lend against income streams. Leveraging from industry or private finance is contingent on whether CHPs can rely on these funds from CRA (and its quantum and incidence) and where this funding source is guaranteed to cover all maintenance and repair costs, rates and charges, as well as any other contractual obligations regarding the development of further social and affordable housing.

Agreements codify interests in sold properties and in repair and maintenance obligations. These agreements are significant and could be onerous. There are high expectations on CHPs to cover current and often retrospective maintenance and repair costs on stock that can be quite old and fatigued. Some transfers also require the CHP to leverage further social and affordable development. The complexity of these agreements might also undermine the value placed on these assets.

3 Valuation standards and methodologies for social housing

3.1 Introduction

The value placed on a social housing asset will vary dependent on whether the purpose is to determine a market value (for sale or purchase), rating value, insurance value, financial reporting value, or for security against debt finance.

In the context of property transfers, transfer of government land and/or buildings requires a value to be placed on the asset at the time of transfer. Its value (or the value of the net income it generates) is of clear importance for social housing providers who take on management of the asset because it will:

- have implications for the capacity to raise finance against it
- have implications for the maintenance burden and ensuring that an asset maintains its value (or at least is depreciated in a way that might be predicted)
- affect the financial sustainability and capital management processes of the providers.

The determination of that value and the issues that may arise for social housing managers is the focus of this chapter of the research. This chapter provides a technical analysis of the valuation of the property asset: it does not try to capture the social, tenant well-being or economic value, which are benefits that can be attached to the asset.

3.2 Valuation standards

In Australia, valuation of public housing is determined by the Australian and New Zealand Valuation Standards (API 2013), which are in turn drawn from International Valuation Standards (2013). Each state is also governed by a *Valuation of Land Act* which determines the valuation of land for government owned assets.

Government owned property assets are valued within property valuation standards and criteria set out by the state treasury or Valuer-General. Principles such as 'fair value' and highest and best use (HBU) are employed in a valuation and these are typically estimating its market value.

In Victoria, the Valuer-General provides the guidelines for obtaining fair value for non-financial physical assets in association with the Department of Treasury and Finance (DTF) (DELWP 2015).

In NSW, the guidelines are provided by the NSW Treasury (2014):

> *The correct valuation of these assets enable an entity to correctly account for the future economic benefits embodied in the assets. This in turn provides the entity with relevant and reliable information for decision-making on the resource allocation, performance measurement and accountability of its assets. (DELWP 2015: 3)*

The valuation must comply with the key aspects of the Australian Accounting Standards Board (AASB) AASB 13, AASB 116, AASB 136, AASB 140 and other relevant AASBs (DELWP 2015; NSW Treasury 2014). The following is a breakdown of the key requirements of each of these standards:

- AASB 13 Fair Value measurement
- AASB 116 refers to the accounting for property, plant and machinery
- AASB 140 Investment property.

Within all of these standards the asset is required to be valued at fair value which is defined in AASB 13, paragraph 9, as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

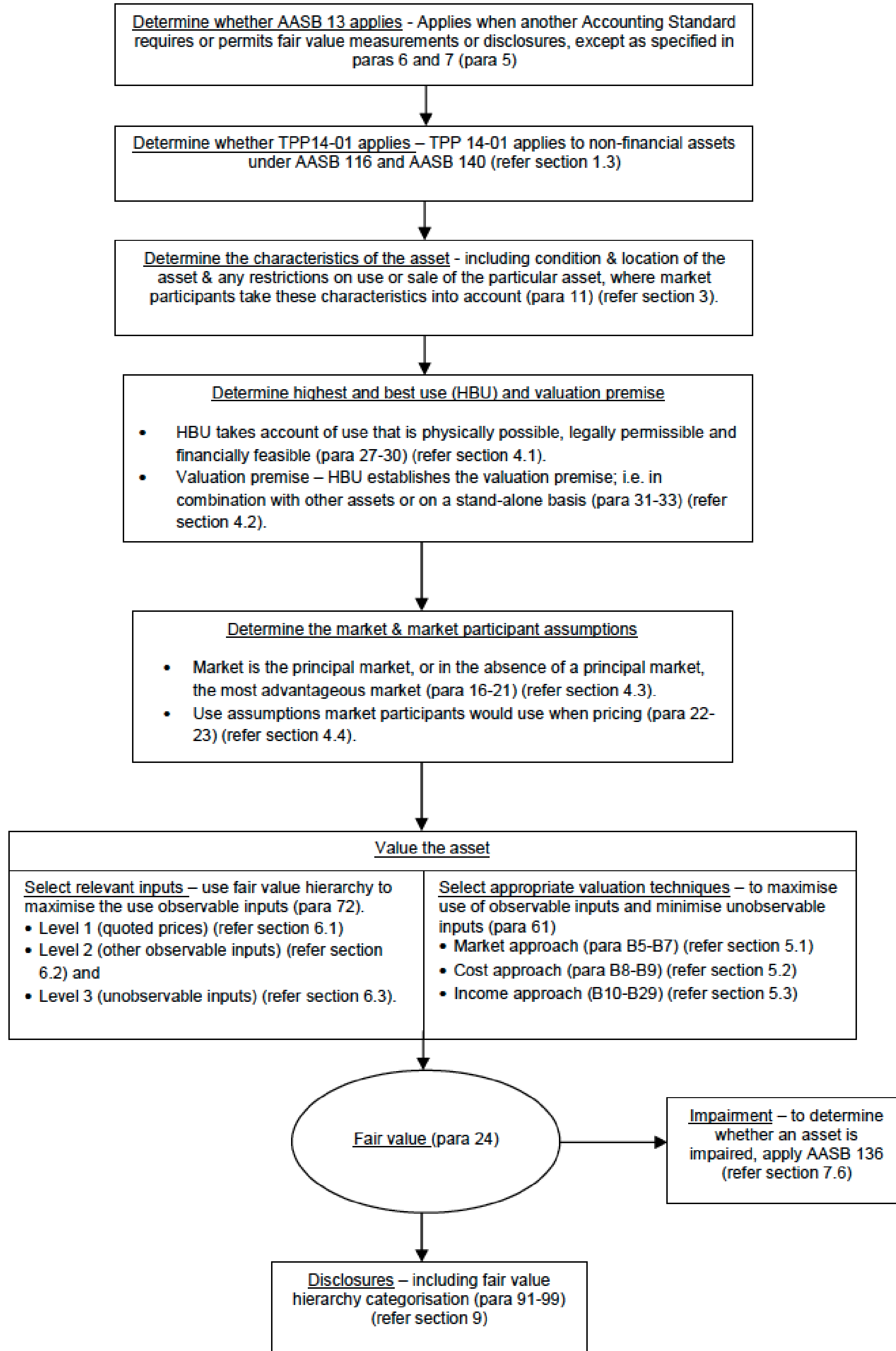
> *The fair value definition is based on the 'exit price' and not the 'entry price' of the asset. Exit price is generally akin to the price that the market will pay for the asset, while entry price is the price that the purchaser will pay for the asset. (DELWP 2015: 7)*

Also relevant in these considerations is 'highest and best use' (HBU). The highest and best use of the asset must be considered in order to obtain fair value which relates to the market value. The NSW Treasury (2014) stipulate in their requirements that they also must comply with the International Valuation Standards (IVS), which are encapsulated in the Australia and New Zealand Valuation standards.

> *The IVSC pronouncements apply for many different types of valuations, including but not limited to financial reporting. In this regard, it is important to note that although the AASB 13 definition of fair value differs from that appearing in the IVS Framework, fair value under AASB 13 is generally consistent with the concept of market value in the IVS Framework. Also, for valuations for financial reporting, where there are any conflicts between the IFRS (on which the AASB requirements are based) and the IVS material, the IFRS (or AASB) requirements prevail. International Valuation Standard IVS 300 Valuations for Financial Reporting also acknowledges this. (NSW Treasury 2014: 3)*

The process for determining Fair value is laid out in a flow chart by the NSW Treasury (2014: 6), as follows:

Figure 2: AASB 13 Fair value measurement—an overview of fair value requirements for non-financial assets



Source: NSW Treasury (2014: 6).

Variation in who values public housing

The Valuer-General has responsibility for determining the value of all state owned properties, although property valuation is sometimes contracted out to professionals (Certified Practicing Valuers). Certified Practicing Valuers must abide by standards and regulations set out by the Australian Property Institute (API) (2013) in conjunction with each state or territory's Valuer-General. Although the responsibilities of the Valuer-General are similar across each state, they may in fact differ slightly in relation to operational procedures between jurisdictions.

Practices vary across the states. NSW use private valuation firms to carry out their valuations for financial reporting purposes, and choose only a sample of properties. As this valuation work is then carried out by more than one company, it means the methodology and databases used may not be consistent, as compared to using one agency. While financial reporting valuations are done every five years in Victoria, they are done more frequently in Western Australia, which values state assets every three years, but only use a portion of the assets.

Importantly, in all states the Valuer-General has responsibility for valuing social housing that is government owned and therefore still falls under the authority of the Valuer-General to determine its value.

Variation in method—market value and financial reporting value

Each public housing asset is valued by the Valuer-General for the purposes of financial reporting on a regular basis. However, they also may be valued by the state to determine 'market value' if the purpose of the valuation is for compensation, transfer, lease, or acquisition. Current market value is always used when determining the value for sale or transfer, while financial values are carried out periodically.

Since Australia follows similar standards when determining market value, these should be consistent between jurisdictions. In determining 'market value' the valuer will inspect the property. This is in contrast to the financial reporting valuation, which is sometimes carried out by desktop and follows the methodology accepted in each state/territory. In most cases, a mix of methods is employed to determine value. The methods used in both these valuations are illustrated in the case for Victoria in the box below:

Box 1: Case study: Financial Reporting Valuation of public housing in Victoria

The valuation of government owned property assets is carried out under the *Valuation of Land Act 1960*. Every property within the state is valued for financial reporting purposes by the Valuer-General Victoria (VGV) every five years. Indexation factors are applied to values in the intervening years. If there is a movement of 40 per cent or more, then more frequent valuations of the asset class are required. Substantial assets are valued using VGV in-house and outsourced valuers following a full inspection, while bulk assets such as Department of Housing estates are valued using a combination of full inspection, kerb-side and desktop assessments. Statistical sampling is used to provide confidence levels.

When valuing for Financial Reporting purposes, this value is split into two asset classes: land and buildings. The Financial Reporting Value (FRV) can be a desktop assessment and assumes the asset is in average condition, which may under or overstate the value if the property is in poorer or better than average condition. The other limitation in the accuracy of the FRV is that they use the database provided by the Department of Health and Human Services (DHHS), which is not managed within one central place, so the accuracy or completeness of the data may not be assured.

The Victorian Auditor General's office carries out regular audits to ensure that fair value is reflected in the financial statements. All government properties to be transferred require an independent valuation from VGV with a second 'check' valuation for properties over $750,000 in value. This process ensures transparency for all transactions. This arrangement is covered under the Victorian Government Land Transactions Policy and Guidelines, April 2016.

Variation relating to Community Service Obligations on public housing

In some cases, public housing on public purpose zoned land make it difficult to convert to private use and this will affect its value. Across all states and territories there is a Community Services Obligation (CSO) which is attached to the title of housing on public purpose zoned land, as the property remains under the Director's authority. This obligation places a restriction on the future use of the property to social housing. The Industry Commission (1997) sets out the definitions for CSOs across each state and territory, which highlights that there are variances across the country. Public housing and the CSO attached to it restricts the future use of the property to social housing. The CSO needs to be accounted for within the valuation for fair value.

CSO is an adjustment for the difference in value between unrestricted assets (e.g. freehold land) and assets held by the public sector, taking into account any legal, financial or physical restrictions imposed on the use or sale of the asset (e.g. restricted land due to a legal restraint).

Examples of assets that are subject to CSO are Crown land in a public use zone and iconic property restricted by legal, physical and financial constraints that would make it difficult to sell on the open market; or, where the constraints would affect the achievable value.

The CSO adjustment is a reflection of the valuer's assessment on the impact of restrictions associated with an asset to the extent that is also applicable to market participants. CSO is the difference between the hypothetical unencumbered fair value based on market evidence (i.e. HBU value without any restrictions) and the value ascribed to the asset based on its current use (existing value restricted by constraints). (DELWP 2015: 13)

In Victoria, VGV has specified the adjustment amount that should be applied to valuing public housing that is located within a public use zone with CSO as 20–30 per cent (DELWP 2015). This adjustment takes into account that the zoning and therefore the use cannot be easily or quickly changed to obtain the HBU value. No CSO is applied to housing stock located on residential zoned land. This same adjustment is not applied across all states, as it is specific to Victoria. In NSW, the current asset use is considered as the HBU unless the use can be changed in the near future, which NSW consider to be within a five-year period. (NSW Treasury 2014)

3.3 Approaches/methods of valuation for public housing transfer

Overseas models

The transfer of public housing is not a new phenomenon with countries such as the UK, Netherlands and the US having embarked on similar exercises in an attempt to involve private sector participation and reduce public control over public housing. In the models of these countries, the transfer has involved large-scale transfer of title and ownership to private entities that manage the public housing stock after the transfer.

Generally, different countries categorise valuation approaches differently for the valuation of assets including public housing. For example, in the USA and Germany there are only three established approaches (capital comparison, investment methods and depreciated replacement cost) whereas in the UK they have adopted a valuation approach specific to, and consistent with, the strategic objectives of property transfers.

As Maclennan and Miao point out 'In essence, the basis for the valuation in determining transfer prices in the UK was the assessed value of the business of being a social landlord. It was not the assessment of open market capital values of the housing and business asset involved. The UK Treasury took view that the latter open market valuation was inappropriate unless it was

assumed government had no commitment to the provision of social housing.' (Maclennan and Miao 2017: 20)

'Australian State Treasuries have adopted the open market full capital valuation approach, and that not only seems somewhat inconsistent with state commitments to public housing, but is also likely to preclude transfers to the non-profit sector (at least without significant increases in rents or tenant subsidies to cover the market valuation of property prices).' (Maclennan and Miao 2017: 20)

The UK Department of Communities and Local Government Housing Transfer Manual states: 'A local authority or tenant group intending to transfer homes will need to generate a Transfer Value using a discounted cash flow model for social housing. This method is understood by the government, the Regulator, funders and receiving landlords.' (Department of Communities and Local Government Housing Transfer Manual, 201: 18).

'We will wish to be satisfied that the Transfer Value has been acceptably optimised in respect of the balance between maximising transfer value, minimising debt write-off, and securing additional private investment which delivers growth and the requirement for overhanging debt write-off is accordingly justified.' (Department of Communities and Local Government Housing Transfer Manual, 2014: 18).

The UK practice is clear and agreed, the valuation method used is fit-for-purpose, fit for the strategic outcomes that the policy is aiming to achieve and aims to balance a number of strategic objectives.

In Australia, there are generally four valuation methods namely:

1. market comparison
2. cost approach
3. income capitalisation
4. residual method of valuation (API 2015).

The purpose of valuation and the particular asset under valuation normally determine the appropriate method of valuation and this is also applicable to public housing. The assets of social housing agencies are specialised and so not transacted frequently on the market. This makes it difficult to determine the value of these assets by making comparison to previous sales.

As a specialised asset, the *cost approach* might be the appropriate method. On the other hand, assets that are similar to the public housing stock in terms of use are traded frequently on the market, such as high rise residential apartments and standalone residential homes. It may be possible to calculate values of such private stock near where public housing is located, thereby enabling the use of the *market comparison approach*. Alternatively, the public housing properties generate income in the form of rents from tenants that can be valued by using the *income capitalisation method*.

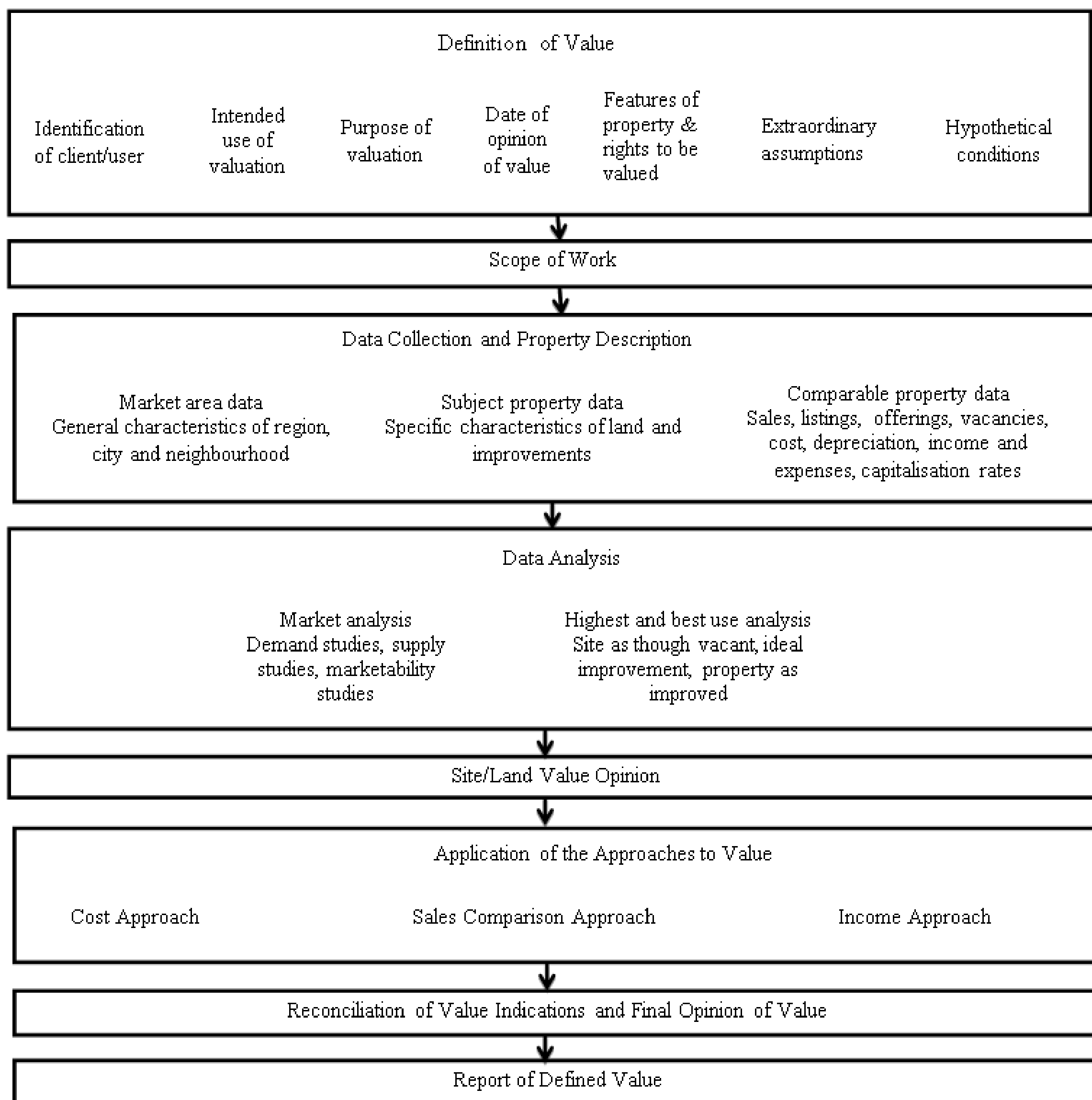
This section does not critique the appropriateness of each method but rather considers the impact of the application of each method on social housing providers. As outlined in the previous chapter, DELWP (2015) and NSW Treasury (2014) have both set out the most appropriate valuation method for public housing as the market comparison method, which is also the method approved and used by the Valuer-General in those two states.

However, at present, there is no consensus on the type of value that must be reported for assets held by CHPs in Australia during a particular financial year. Different states report different types of values for assets (land and buildings) which means that different valuation

methods are also used to determine the values that are reported at the end of each financial year (Productivity Commission 2012, Table 16A.85). The problem is compounded when the purpose of valuation is for the transfer of the assets to a third party because the transfers within social housing have been limited, until recently.

In providing a review of the methodologies of valuation, the focus is on the methods prevailing in Australia for the valuation of land and buildings. As a result, three out of the four main valuation methods mentioned above will be the focus of the discussion. These methods include the market comparison approach (often called the sales comparison approach), cost method (sometimes called the summation approach), and income capitalisation. The residual valuation method is excluded because it is generally used for evaluating property development projects rather than the valuation of existing buildings. See Figure 3 below for a diagram of the valuation process.

Figure 3: The valuation process



Source: Adapted from API (2015).

3.3.1 Market comparison approach

The market comparison approach is a prominent method of valuation. It is in some senses present in all the other valuation approaches because a valuer must have some reference point to compare the subject property (i.e. the property being appraised) to form the opinion of value (API 2007). The method uses the transacted prices of similar properties that have recently been sold to determine the value of the subject property after proper adjustments. This is based on the assumption that the sale price of a similar property is closely related to the value of the subject property since both are located in the same property market. In the appraisal process, the valuer gathers recent sale prices of similar properties and makes adjustments in terms of the differences in characteristics such as size, age and condition to arrive at the value of the subject property.

This approach is based on the principle of substitution. Obtaining similar residential properties within the private market is relatively straightforward, however social housing is much more difficult, with none or limited transactions within the specified location. The use of private sales can be used as comparable; however adjustments would be required to account for any differences in condition.

A comparable property is therefore one with similar features as the property under valuation in terms of location, asset characteristics such as size, aesthetics, age, planning restrictions, land size and other features deemed relevant in forming an opinion of value. Generally, the unit of comparison between the subject property and its comparable property is locally driven depending on the property market and valuation requirements. It is therefore the duty of a valuer to do thorough research to determine the unit of comparison in a specific market for valuation purposes.

In most instances, residential property valuers adopt the dollar per square metre analysis and adjustments are made to the comparable value to reflect the value of the subject property. In arriving at an opinion of value for public housing, it is possible to adopt the market comparison approach especially in large cities where evidence of comparable transactions is available. Because valuation is not an exact science, it is advised that a secondary method be used to serve as a check on the value derived from the market comparison approach. Broadly speaking, the valuation of public housing in Australia has been based on market evidence of equivalent assets, although this differs among jurisdictions (Pawson, Milligan et al. 2013).

Both the Victorian and Tasmanian Treasuries advise to use the market comparison approach to value public housing. In Tasmania, market value for financial reporting purposes is estimated using five-yearly Valuer-General data. This is land value, capital value (land plus improvements) and annual value (rent, which must be no less than 4% of capital value), with total value adjusted for market movements.

3.3.2 Cost approach

Another approach that can be used in determining the value of a public housing stock of residential properties is the cost method. This approach is not commonly used for residential property, however it is arguably the most logical approach when valuing an asset that is provided for a public good, where the cost of replacement provides the value and the use or zoning is not changing.

Public housing in Australia has historically been valued for the purpose of obtaining a financial reporting value for the government's assets, rather than as a market value to sell or transfer the title of the asset. In some states the financial reporting value is calculated as a depreciated cost value, based on average condition of the asset.

As already indicated, the choice of valuation methodology is highly dependent on the nature of use of the subject property and the purpose of valuation. In instances where the property being

appraised is so specialised that the property is not frequently traded on the property market as a result of its design or location, it is difficult to obtain information on comparable properties for the valuation of such properties. Similarly, in instances where there is no rental or rents paid by tenants occupying the property, or the rents are not at market level, there is difficulty in using the investment (capitalisation) method of valuation, hence the best secondary method is the cost approach. This is similar to the public housing operations in Australia where rents payable by tenants living in public housing are tied to their level of income, but are not set at the market rent.

In using the cost approach to determine the value of a property, the depreciated replacement cost of the property (improvements) is added to land value (summation of values). Normally, the land value is determined through the use of comparable sales and the replacement cost of the improvements is determined using the current construction cost of the subject property. The replacement cost will then be depreciated using a subjective rate of depreciation to arrive at the depreciated replacement cost of the property. This is done because the method is based on the principle of substitution where a buyer is only willing to pay for the cost of reproducing the asset in case there is no alternative way of determining value.

In using the cost approach method, value is given by:

$V = C - D + L$

where *C = Cost of constructing a similar building as at the date of valuation,*

D = depreciation on the cost of the new building and

L = land value.

In summary, the depreciated replacement cost method is equal to the sum of land value and the depreciated value of the cost of reconstructing the building at the time of valuation. The imprecision associated with this method is its main weakness as there can be bias in the choice of the rate of depreciation leading to an inaccurate valuation.

3.3.3 Income capitalisation

Another approach is the income capitalisation approach. This approach is based on the principle of anticipation—the anticipation of the future cash flows derived from the use of a property. This shapes the perception of market participants to value a property at a certain price and date in a particular property market. The income stream and allowing for any shortfalls between the actual rent and market rent needs to be considered. This valuation approach is commonly used when valuing investment property with income streams, which would include nearly all commercial property. A discounted cash flow approach is also based on the income stream and would use a discount rate to determine the value. This method allows for forecasting income along with expenses. Any maintenance or capital works can be accounted for within the cash flow. A condition assessment is therefore critical to determine any deferred maintenance at the time of the property transfer.

Properties can be owned and occupied by the owner, or the owner may decide to lease the property to a tenant (third party). In return for leasing the property to a tenant, the owner receives a rent for forfeiting the occupation. In this case, the property becomes an investment asset that generates revenue for the owner. Under such a circumstance, the income capitalisation approach provides a basis for making comparison between properties sold recently within the given market and the subject property under valuation (API 2007). The comparison is generally done from two main perspectives: first, through the determination of a net rent level that can be generated by the subject property after making comparisons with similar properties that have recently been let out in the market and second, the most probable achievable capitalisation rate for the subject property.

Generally, this method is applicable to all the different property asset classes including residential apartments or units, shops and offices that are generating income in the form of rents to owners. In most cases, other non-core property asset classes such as hotels and motels are also valued by using the income capitalisation method (API 2007). In contemporary property valuation practice however, the income capitalisation approach can be categorised into two methods: direct capitalisation and the discounted cash flow technique, which are discussed below.

3.3.4 Direct capitalisation

The direct capitalisation is part of the income capitalisation method, which uses a net maintainable rent and a capitalisation rate to capitalise property value into perpetuity. It assumes that there is a net maintainable rent that the property will generate in perpetuity and hence the capacity of the property to produce such a rent level must be the basis for its valuation. For such income producing properties, there is potential for risks and uncertainties inherent in the investment property and hence the method uses the capitalisation rate to reflect those risks such as vacancy, short-term tenancy and low demand. The higher the risks identified, the higher the rate of capitalisation and vice versa.

In using direct capitalisation, the formula for calculating value is:

$V = i / r$

where V = *Value,*

i = *Net Income and*

r = *Capitalisation rate*.

The capitalisation rate is generally determined through the analysis of comparable sales similar to the subject property but adjustments are made to reflect general risks such as property condition and changes in the market. Failure to derive an accurate capitalisation rate can lead to serious valuation errors.

3.3.5 Leasehold value (discounted cash flow)

For properties that are held under a long-term lease agreement, the lessee holds a registered interest in the property asset. This value is not as high as the freehold unencumbered value as there is no ownership of the asset, although there is still a registered interest, in the form of a long-term lease. This lessee (CHP) interest is calculated based on the discounted future income stream generated from the asset. The discount rate that is applied to this income stream is subjective and dependent on the risks associated with maintaining the income stream. (API 2007: 6.2.1)

3.4 Risks or issues that may arise when valuing public housing

There are risks in using particular valuation methods and valuation of social housing raises a few additional issues that are not as evident in the valuation of other property asset classes. Some of the risks or issues associated with valuations of public housing are outlined below.

It may be argued that due to the risks and shortcomings outlined below, that the current methods for valuing social housing need to be reassessed.

3.4.1 Income-based rents are well below market levels

In order to value using the Income approach, the ‘market rent’ needs to be determined. The International Valuation Standards (IVS) refers to the income approach as being: A *valuation*

approach that provides an indication of value by converting future cash flows to a single current capital value (International Valuation Standards 2013).

One of the issues that needs to be addressed in determining future cash flows and market rent when dealing with social housing is that rents in social housing are generally limited to approximately 25 per cent of income, which will generally be well below rents prevailing in the market. Rents can also be supplemented through CRA, but even with CRA the total rent will generally be below market. An adjustment to the shortfall in rental will need to be made, to be able to determine the net operating income. As the formula has a multiplying effect, if the rental figure is not a true reflection of the market rent then a significant under or over valuation can occur.

3.4.2 Problems in calculating a capitalisation rate

In calculating returns for property yields, CHPs need to calculate a capitalisation rate. This calculation is based on returns achieved from similar market transactions, taking into account the risks associated with achieving the income. With social housing, the issue that needs to be investigated is how the risk factor would be determined given the capitalisation rate used.

3.4.3 Onerous lease obligations

As the net operating income includes building operating expenses, it is important to identify any clauses within the lease agreements that may place a more onerous responsibility on the CHP for expenses such as capital works or unplanned deferred maintenance. The income approach uses the net operating income as the basis to determine the value of the building. The lease will also refer to future capital expenditure and planned maintenance to occur following the transfer. All of these may affect the valuation of the income flows and property valuation.

3.4.4 Economic and property risks

There are other risks in valuing public housing relating to the economy and property market. Factors might be macroeconomic in nature. For example, the lowering of interest rates in the early 2000s has made housing more expensive, making it more expensive to acquire new stock. Demographic change (in particular the ageing population) might also affect government's capacity to provide welfare to retirees at current levels (Gahan 2015).

More localised risks might also emerge. For example, it is well known that capital city markets have evolved differently from regional markets. This is particularly problematic for smaller providers as they have less ability to spread their asset pool across areas meaning a higher level of risk exposure.

3.4.5 Tenancy risk

Meeting current needs while simultaneously preparing for future demands is a major challenge for social housing providers. The profile of social housing tenants is changing, for example, through changes in patterns of family formation or the ageing demographic, and this may pose risks for viability.

3.4.6 Risks of reduction or cessation in CRA on borrowing capacity or portfolio expansion

The valuations based on income-based methods are dependent upon future projections of income. If the CRA were to be reduced or cancelled, this would have the effect of reducing the total income of the CHPs. For example, should the total income of a CHP reduce to $100 million per year as a result of cancellation of the CRA, with identical expenses and interest payment, the earnings before interest and tax (EBIT) will be $25 million. The Interest Cover Ratio (ICR) for the CHP in question will be 0.83 which is less than 1, making the CHP incapable of meeting

debt obligations. This could undermine the ability to secure funding from banks for operations. If a CHP is unable to generate enough cash flows to meet recurrent expenditure, it can be argued that the CHP in question cannot expand the portfolio due to lack of capital.

This is a demonstration of the importance of the borrowing capacity of the CHPs because it is the total income that can potentially be generated by CHPs that determines the amount a financial institution will be willing to give to a CHP as debt capital. The higher the potential income, the higher the debt capital and vice versa. Because the ability of a CHP to develop and expand the portfolio is based on the capital resources available, any change in the rental projections as a result of cessation of CRA would negatively affect the ability of the CHPs and their operations as demonstrated with the hypothetical case scenarios.

3.5 Valuation impacts on borrowing capacity

To demonstrate the impact of the asset value on borrowing capacity, a case study approach has been chosen. CHPs, as with any private entity, can borrow against the value of the cash flow under a registered lease, or against the asset if they hold title. Since financial institutions normally provide loans or debt capital based on the value of the asset(s) of the borrowing entity used as collateral, valuation is important in determining the exact amount that can be advanced to a CHP as debt capital. This may be in the form of what is generally termed as loan-to-value ratio (LVR) where banks examine the value of an asset and advance loans based on the asset's potential value in an open market.

Restrictions on loan-to-value ratios (LVRs) differs considerably from one bank to another due to varying risk tolerance levels within the institutions. The interviewed CHP stakeholders generally agreed that the LVR is limited to between 20 per cent and 30 per cent of value of the asset. Due to the dependence of the income stream on the value of the asset and total portfolio that can be used as collateral, it is important to examine the effect of variations in the value of a portfolio due to the use of different valuation methodologies.

As already explained under Section 3.2, the determination of value of an asset (property) requires different approaches and, depending on the approach, differences in value may occur. Any variation in the value has the potential to impact on the amount of borrowing that a CHP can raise for its operations and expansion based on the LVR measure.

Depending on the location and other features of the assets, a specific choice of valuation method can be adopted to determine the value of an asset, as outlined in the previous section. As the LVR is dependent on the value of the assets, the debt funding as a percentage of value may also vary. In the next section, a hypothetical case of a house is valued using the three different approaches on the assumption of true market value with no restrictions based on the highest and best use for the property.

3.5.1 Market comparison approach

Using the market comparison approach, a valuer collects data on similar properties that have recently sold and uses the information as a proxy to determine the value of a subject property. The information is on a like-for-like basis (substitution approach); one bedroom for one bedroom and likewise two bathrooms for two bathrooms. Therefore, under this hypothetical scenario, a valuer will collect information on the sale price of comparable properties that have similar features to the subject property in terms of location, finishes, land size, building size, number of bathrooms, kitchen size, living room, type of construction, age of the building and other relevant factors for the determination of value. The information is then compared to the subject property and price adjustments are made to the sale prices of the comparable sales in order to determine the potential sale price of the subject property.

Table 1: Market comparison data on subject property and comparable properties

	Subject property	Comparable 1	Comparable 2	Comparable 3
Sales price		$510,000	$470,000	$450,000
Age in years	10	5	7	12
Bed	4	4	5	4
Bathrooms	2	3	2	3
Floor area	286	310	298	270
Lot size	862	885	1,428	867
Car spaces	2	2	1	1
Additional amenities	No	Yes	Yes	Yes
Views	Good	Better	Worse	Better
Condition	Good	Better	Worse	Good

Source: Authors 2017.

Using a four-bedroom house as a case scenario for a hypothetical valuation as demonstrated in Table 1 above, the relevant features that are needed for the valuation are captured, tabulated and juxtaposed to the subject property in order to do the comparative analysis to arrive at the necessary adjustments. As evident from Table 1, features that have impact on the final value such as age, floor area, number of bedrooms and bathrooms, land size, amenities, views, condition and car spaces have all been captured.

The valuer then determines the specific amount that must either be deducted or added to the sale price of specific comparable to reflect the value of the subject property. This is highly dependent on available data and the subjective opinion of the valuer based on experience and knowledge of the specific housing market. The valuer arrives at adjusted property prices for the subject property and makes a determination of the final valuation.

Table 2: Hypothetical valuation using the market comparison approach

	Comparable 1	Comparable 2	Comparable 3
Sales price	$510,000	$670,000	$450,000
Age	- 5,000	- 3,000	-
Bed/Bath	- 8,000	- 5,000	- 8,000
Floor area	- 20,120	- 14,820	- 19,600
Lot size	- 11,546	- 229,604	- 2,450
Car spaces	-	2,000	2,000
Additional amenities	- 3,000	- 3,000	- 3,000
Views	- 10,000	10,000	-15,000
Condition	- 20,000	15,000	0
Adjusted sales price	$432,334	$441,576	$443,150

Source: Authors 2017.

Table 2 above demonstrates the hypothetical adjustments made to specific comparables to reflect the potential price of the subject property. These figures are only for hypothetical purposes and in no way represent an assumption of value for social housing. For example, after all adjustments to Comparable 1 in Table 2, the adjusted price of the subject property is likely to be $432,334. In this case the valuer may decide to adopt the value that is appropriate and mimics the features of the subject property as much as possible. In this hypothetical case for example, the valuer may decide to choose a value of $432,334 as the value of the subject property based on the valuer's judgment and experience.

Since the LVR is between 20 per cent and 30 per cent, the range for debt capital that can be secured using this asset ranges from $86,500–$129,700. This means that the higher the value of the assets, the higher the debt funding that may be received from the banks to finance the operations of the CHPs and to expand the portfolio. Similarly, the lower the value of the assets, a lower amount of debt funding may be attracted and can hamper the activities of the CHPs in delivering their objectives of maintaining or increasing supply.

Using this same example, if the restriction in use to social housing or CSO is applied this may reduce the value of the property by 20 per cent to $346,000 which would therefore reduce the lending ability to $69,000–$104,000 based on an LVR of 20–30 per cent.

3.5.2 Income approach

If the income approach was used to value the property, the valuer is now focused on the income generation from the property rather than comparable properties.

CHPs can currently obtain additional revenue through the tenant's access to CRA. CRA is a non-taxable income supplement, payable fortnightly to eligible recipients. The CRA is paid at 75 cents for every dollar above a minimum rental threshold until a maximum rate is reached. The minimum threshold and maximum rates vary according to an income unit's household composition, including the number of children. The median CRA payment at 30 June 2015 was $128 per fortnight, and the median rent was $415 per fortnight (AIWH 2016b).

In the previous example, we have a four-bedroom property. If the market rent for the property was $450 per week (Corelogic RP data Jan. 2016, Melbourne) the annual gross income from this property would be $23,400.

Any reduction in the CRA will have an impact on the income generated through rentals to the CHP. If the income is reduced there is an impact on the asset value when valuing using an income approach. To illustrate this, a simple example follows: As discussed above in Section 3.2.4, the income approach is calculated using the following formula: V = i / r. The market capitalisation rate (r) will remain the same as this is reflecting the current market return, and is not altered by the generated income. For this calculation we are only concentrating on the 'i', which is the net income. If the 'r' is 5 per cent and our gross annual income, at market rates, for the four-bedroom house is $23,400 then the value is $468,000 ($23,400/0.05).

As the property is held by the CHP, the income is not a market rate, but is instead restrained to being around 25 per cent of the tenant's income. The median rent for social housing is provided by the AIHW (2016b) as being $415 per fortnight, which equates to $10,790 per annum. The CRA payment is $128 per fortnight (AIWH 2016b) equating to $3,328 per annum additional income for the CHP for this property. Combining the rental and the CRA, we have an annual income of $14,118. Using the income approach to value the property would equate to a value of $282,000 ($14,118/0.05).

If the net income was to drop through a reduction in CRA to $60 per fortnight, then the annual income (rent plus CRA) would drop to $12,350 and the value would then drop to $247,000 resulting in a loss in asset value of $35,000. The effect would be a reduction in asset value, while at the same time reducing the CHP's ability to borrow money against the asset/income stream.

The following table highlights the impact that the difference in value will have on the level of debt achievable on that asset.

Table 3: Valuation summary

			Drop in CRA by 50%	LVR @ 20%	LVR @ 30%
Market comparison approach	Full market value	$432,334	N/A	$86,500	$129,700
	Social housing	$346,000	N/A	$69,000	$104,000
Income approach	Full market value	$468,000		$93,600	$140,400
	Social housing	$282,000		$56,400	$84,600
		$282,000	$247,000	$49,400	$74,100

Source: Authors 2017.

The condition assessments of properties also have an impact on the net income. The definition of 'net income' is the gross realised income minus the operating expenses, which includes maintenance. In the example above, the rent income was reduced through a hypothetical drop in CRA, but this same effect will occur with any increase in operating expenses/maintenance. If the gross annual income is $10,790 and the maintenance cost increases then the net income will reduce which then translates into a loss of value.

As stated in the previous chapter, the Victorian and Tasmanian Treasury both advise to use the market comparison approach to value public housing (DELWP 2015; NSW Treasury 2014). The above example demonstrates that there appears to be advantages in this approach: the income capitalisation approach would lead to lower values which relate to the low value of net revenue streams. However, it is used here as a comparison to illustrate the difference in value when there is a lower rental stream.

3.6 Valuing special purpose housing

The provision of housing for tenants with either a physical disability or alternatively aged care, requires the provider to adapt the unit or house to cater for those needs. In many instances this will include, but not be limited to, installing access ramps, widening of doorways and passages, and modifying kitchens and bathrooms. These additional services or alterations will incur additional costs over and above the standard house plan. The cost of these additions will normally exceed the additional value placed on the asset. This is common to many housing provisions, disregarding whether they are public or private housing. For example, double ovens, multiple bathrooms, etc. only add value if there is a market for those provisions.

The added value is also dependent on the type and purpose of the valuation. If the valuation is for replacement insurance, then the additional cost would be considered, as the valuer is determining the cost to replace. However, if the valuation is for raising debt or market value then the value is based on the market comparison method and therefore the demand. A positive adjustment would be made for those facilities, but not necessarily the full replacement cost.

3.7 Summary

While there are challenges in determining value for property transfers, these are not insurmountable. More problematic at present is that there is no consensus on the type of value that must be reported for assets held by State Housing Authorities (SHAs) in Australia in relation to market value. The value placed on the property on transfer will have a large impact on the ability of the CHP to maintain the property condition, and also raise debt against existing stock to build their portfolio.

Australian practice, as yet, does not have the same clear thinking about the strategic objectives being pursued, as we are using a valuation method designed for other purposes that ignores the policy purpose of a property transfer.

In Australia, most stock transfers have been management transfers. Where assets have been transferred, the SHA has generally been transferring properties at zero dollars to the CHP. This reflects the heavy requirements in relation to the corresponding social benefit these providers are required to produce (and would need to be recognised within the SHA books) that would offset the value of the properties.

In other cases, asset transfers have occurred via SHAs transferring assets via long-term lease with the CHP (e.g. in NSW). In these cases, no title is transferred, but this generates a lessee interest in the property asset. A value can be attached to this. As the CHP is usually limited in its ability to borrow funds against its cash flow, the lessee value is useful in providing security for the CHP taking on debt. However, the asset value of a long-term lease is considerably less than the freehold (title transfer) value.

The evidence in this chapter shows that the market comparison valuation method will provide much higher values for housing transferred, and therefore provide much greater capacity to borrow against that asset. By contrast, income methods of valuation, because they reflect lower cash flow, will result in lower valuations and therefore lower capacity to borrow.

However, in the case of local property transfers in which title is not transferred, debt would need to be raised on the back of cash flows deriving from long leaseholds. So for debt raised on a lease, the cash flow is the critical component, rather than the asset value. The lease term is also important for the creation of the debt, as the financiers' security will only extend as long as the lease term. In the lease scenario, any reduction in generated income through lowering of rents or reduction in CRA will have a significant impact on the borrowing capacity. This impact will then flow onto the CHPs ability to carry out improved property standards and/or expansion of stock. The same effect can also be felt if there is an increased expense related to property maintenance as this will reduce net income and therefore borrowing capacity.

The market valuation placed on the stock will be more important to the CHP if the title is transferred, as the CHP will be looking to raise debt through the asset value (though both asset value and cash flow are relevant to secure the debt). If CHPs seek to renew stock by selling and purchasing on the market, the market-based method—which emphasises substitution—seems appropriate. A drawback for this valuation method would be that if the CHP seeks to redevelop or repair old sites or upgrade to new purposes it could face high replacement costs. The condition of existing assets and the costs for upgrading is of high importance since market value may not reflect these expenses.

The value of the asset will be reduced where there is a restriction on the use or development of the site—this might have a disproportionate effect on the level of borrowing that can be achieved. Fortunately, each state allows CHPs to dispose property that is locationally obsolete or in poor condition, with approval from the Director of Housing, so that funds can be used to purchase property in better condition and in an appropriate physical setting. The CHP is required to submit a business case to the SHA to progress this transaction. This transfer of location and amenity of stock, will have the added benefit of ensuring the tenants' needs are better served.

Either the market or income valuation method can enable asset valuation. This can facilitate borrowing which can generate improved or growth in assets and wider community benefit. A CHP can also take advantage of the cash flow generated or added asset value to ensure tenants are able to enjoy a well maintained property in good condition.

4 Optimal capital management

4.1 Introduction

Property transfer can facilitate improvements in the way Community Housing Providers (CHPs) grow by increasing the number of dwellings under management which has the potential to increase supply of affordable housing.

Critical in this process is how CHPs utilise capital—financial and physical—to manage sustainability and growth in their organisation. Property transfer can play an important role in enabling growth, either by adding to the physical asset base, or facilitating access to new forms of debt finance.

CHPs will need to understand the implications of asset transfer valuations on the way they manage their capital resources—they will need to know what is best for them in terms of getting the appropriate mix of physical and financial capital, debt versus equity, investing in new stock versus old, including decisions over having cash flow on hand to meet ongoing maintenance expenditures or whether it can be ploughed into new stock.

Good capital management practices or techniques might help a CHP optimise:

- securing finance to enable development of new assets
- timing of selling or redevelopment of old assets
- financial sustainability so that it does not need to run down its asset base (e.g. by cannibalising its own stock to fund running costs of other stock).

The remainder of this section draws on the records of interviews with financial organisations, CHPs and government officials involved with property transfers. It seeks to understand capital management practices that will optimise outcomes for CHPs from stock transfer. These are:

- ensuring CHPs can secure debt finance
- ensuring sufficient cash flow to meet ongoing costs and interest costs
- due diligence in appraising conditions of existing stock to limit risks
- operating at appropriate scale
- leveraging debt to redevelop old stock and create new stock
- minimising risks of default.

4.2 Ensuring CHPs can secure debt capital/finance

The capital structure for CHPs can consist of both debt and equity. Whereas equity is the capital contribution from the CHP, debt capital is sourced from financial institutions. It is an important complement to equity finance as it can enable companies to take on more risk and grow.

Due to risks associated with debt lending, financial institutions generally require some form of collateral as security to defray the debt in the event of default by the borrowing entity. Financial institutions generally demand real property for use as collateral because it is the most secure asset. Therefore, CHPs can secure debt capital against assets (property) under their management or ownership, depending on the type of transfer and with approval from the entity transferring the stock. CHPs face other challenges which stem from SHAs holding an interest in the properties, even when title is transferred to the CHP. Such encumbrances on title, including mandatory caveats placed on titles by SHAs, may dissuade or delay finance companies from lending to CHPs.

In lieu of using assets as collateral for debt funding, CHPs have the option of borrowing against the cash flows that are generated from their operations. In this case, the CHPs do not need to use the portfolio (stock) as security against the debt but need to demonstrate the viability of their business to generate enough cash flow to service the debt payments. The asset transfers as presently structured have relied mainly on this form of debt funding from cash flow. CHPs can borrow against the value of the cash flow under a registered lease but since financial institutions normally provide loans or debt capital based on the value of the asset(s) of the borrowing entity used as collateral, valuation is important in determining the exact amount that can be loaned to a CHP. This may be in the form of the loan-to-value ratio (LVR) where banks examine the value of an asset and advance a loan based on the asset's potential value in an open market.

Restrictions on LVRs differ considerably from one bank to another due to varying risk tolerance levels within the institutions. The CHP stakeholders interviewed in this Inquiry generally agreed that the LVR is limited to between 20–30 per cent of the value of the asset. The NSW interviewees understood that many properties have a loan-to-value ratio of around 25–35 per cent and CHPs can mortgage these properties to obtain finance for maintenance and further development or redevelopment. Due to the dependence of the income stream on the value of the asset and total portfolio that can be used as collateral, it is important to examine the effect of variations in the value of a portfolio due to the use of different valuation methodologies.

4.3 Ensuring sufficient cash flow

Cash flow will be important for a number of reasons in terms of managing stocks and flows of capital:

1. The debt capital sourced from financial institutions by CHPs depends on the ability of the CHPs to generate enough cash flow (e.g. from rent revenue) to secure against the debt payments over the length of the lease.
2. Cash flow needs to be sufficient to cover interest and principal.
3. Cash flow might be subject to risks including sovereign risks and lack of take up by tenants.

Debt capital depends mainly on cash flow

Interviewed respondents indicated that CHPs mostly borrow against cash flows, as they do not hold the title. This is similar to the findings from a study conducted by Pawson, Martin et al. (2016) and reinforced by Sphere (2010) who stated: 'When it comes to borrowing, capacity to repay debt is the limiting factor not security'. Therefore, by implication, the debt capital sourced from financial institutions by CHPs does not necessarily depend on the value of assets, but the ability of the CHPs to generate enough cash flow to secure the debt payments over the length of the lease.

CHPs therefore need to have good understandings of future cash flows, including rental projections and benchmarks, by which to assess viability. The rental model used in estimating the potential total rent and the associated viability of the business (included in the tender documents for many of the transfer processes in Australia) is based on the consistency of cash flow of the rents and the accuracy of the projection levels used in the modelling. The potential total rent includes the CRA, along with a rent based on the percentage of income. This calculation, because of the sub-market rents charged and depending on the geographic context, may still leave a 'yield gap' to a financially viable situation. .

Cash flow must exceed interest costs

If a CHP has to borrow based on cash flow instead of value of asset, the main measure used by the banks is the interest cover ratio (ICR). It is a method used by banks to assess the ability of

firms (CHPs) to meet financial obligations; interest payments in addition to the principal. The banks do this by using the ICR to determine the ability of a CHP to generate enough cash flow to service its debt.

The ICR is the ratio between earnings before interest and taxes (EBIT) generated by a borrower in a year and the total amount payable as interest expense. It indicates the borrower's ability to pay interest on its total remaining debt and the extent to which earnings can decline before the company is unable to meet its annual interest expenses:

- A higher ICR indicates that a borrower is highly solvent and capable of meeting debt obligations. Generally, an organisation’s ICR should be above 1.5 and ideally be between three to four times the cash flow, but it differs from industry to industry and it is much dependent on the industry benchmark (Hoggett, Medlin et al. 2015).
- An ICR below 1 indicates the inability of an organisation to generate sufficient earnings to service debts and meet other financial obligations, and this suggests a likelihood of a borrower defaulting on payment.

A CHP must be able to meet the industry benchmark set for ICR in order to be considered by financial institutions for debt capital because that level of ICR offers a margin of safety in case any unforeseen financial challenge arises. One of the participants interviewed indicated that, ‘our income generated from all sources must be at least 2.5 times the amount paid in interest each year’. Another participant gave an ICR range of 1.6–1.8 times the total income generated in a year. A major inference from this is that it is extremely important for the CHPs to generate a level of cash flow and the industry benchmark for ICR may be between 1.6–2.5 times the earnings before interest and taxes (EBIT).

In view of this, a hypothetical case study is used to demonstrate changes in rent levels and their impact on borrowing capacity and by extension the ability of the CHPs to expand the portfolio (see Box 2 below).

Box 2: Case Study: Using interest cover ratios to manage debt exposure

Using a hypothetical case (base case) of a CHP generating a cash flow of about $150 million, expenditure of about $75 million and an interest expense of $30 million, the CHP would have an ICR of 2.5, which is effectively within the industry benchmark. This suggests that the CHP in question is highly solvent under the hypothetical scenario and still retains extra capacity to borrow more for its operations. Thus, the CHP can borrow funds until the ICR decreases to about 1.6 which is allowed by the financial institutions in the case of the CHPs as argued earlier. Any CHP under this circumstance can be deemed to be generating enough cash flow to meet expenditure and still has surplus to reinvest into the portfolio and further expand supply or to redevelop/maintain existing supply. Thus, the CHP’s cash flow and profits are so strong that financing the business can be achieved via retained earnings.

Sovereign risk of changes in income

Because most CHPs borrow against cash flows, this means CHPs are exposed to considerable sovereign risks in respect of the leverages that are secured against the cash flows (Pawson, Martin et al. 2016). This is because the cash flows are highly dependent upon income sourced from the Federal Government. Tenant incomes are mainly from income support. The rents payable are limited—for example, in Tasmania, the rent payable is 25 per cent of tenant’s income plus CRA. Therefore, any change in government legislation that affects income support payments or CRA and therefore rental projections can have serious implications for the business plans of the CHPs and their viability as business entities. Nevertheless, the addition of

CRA is a crucial benefit to CHPs not available to public housing authorities. As Pawson, Martin et al. (2016) argue: 'all other things being equal, a transfer that added CRA to rent revenues could indeed 'make all the difference' in terms of meeting operational expenditure needs'.

Any variations in the cash flow projections can be detrimental to the operations of the CHPs. The impact of changes in legislation, or where title is transferred and tenants do not sign up for CRA will impact the cash flow and therefore affect a CHP's ability to maintain, expand or redevelop stock. When CHPs gain long-lease acquisitions of former public housing, they are put into a better position for cash flow-based lending (Pawson, Martin et al. 2016). Concurrent lease arrangements, as is the case in NSW and South Australia, ensures that ownership of the asset remains with the SHA while also permitting tenants to make use of the CRA program. By contrast, Victoria and Tasmania have remained with general leases, which provides flexibility to tenants as to whether they remain in public housing or switch to CHP and sign up for the CRA. As it is not a compulsory requirement, CHPs cannot be guaranteed that 100 per cent of the CRA eligibility will be realised, meaning they cannot accurately predict total cash flow.

4.4 Operating at scale

A key objective of property transfers is to increase the size of CHPs so that they might generate scale efficiencies. There may be efficiencies in relation to property management and access to reduced costs of borrowing when an organisation reaches a certain scale. Therefore, governments give consideration to how transfers build scale, and prioritise transfers to larger organisations willing and able to achieve an efficient size.

In all states, interviewees commented that portfolio transfers that are small in scale (500 properties or less) are not financially feasible as CHPs are unable to spread their overheads across enough assets. The overheads include staff, IT, rent for offices, marketing costs as well as the asset management costs.

From the interviews, it is apparent that even with the benefit of being exempt from GST on property costs and gaining access to CRA, the CHPs still only derive a marginal profit from each asset. A larger scale portfolio allows for a greater spread of overheads and may therefore be more feasible.

It was clear that in smaller jurisdictions (Tasmania and South Australia) successful tenderers tended to be larger national organisations that benefit from their existing scale and increased capital base. In Tasmania, asset transfer followed management transfer, and the tender was limited to existing providers of management (who were all large national providers).

4.5 Leverage/capital renewal

By virtue of contractual obligations imposed on CHPs by SHAs, there is the expectation that CHPs will leverage transferred properties to cover not only maintenance and repair costs, but also fund new social and affordable housing development.

At the time of transfer, the CHP may enter into a contract with the government to commit to supply a target number of new social housing dwellings (e.g. if they received 100 dwellings, they may commit to deliver an additional five dwellings over a period of 10 years). In NSW this was termed a 'leverage target'. This target differs from CHP to CHP and should be reflected in their business plan. In Tasmania, supply was a secondary objective given the lack of scale involved, although incentives were provided to do this, such as the ability to receive proceeds of sold properties, donations of vacant land suitable for development as well as the capacity to use properties for both key workers and for social housing.

CHPs also need to plan for renewal of stock over a period of time. CRA-enhanced rent revenues offer the opportunity for CHPs to maintain, upgrade and plan for stock. CHPs can leverage the cash flow generated to ensure tenants are able to enjoy a well-maintained property in good condition. In cases of asset (rather than just management) transfers, CHPs will also need to fund new capital for any major reconfiguration. This will mean making allowance for depreciation of existing assets and these are factored into future cash flows. As with maintenance costs, an understanding of the capital costs, timing of capital and the depreciation method needs to be fully understood by both parties in the transfer process.

4.6 Managing risks of default

In the limited number of cases where title is transferred to the CHPs, they can then borrow against the asset, as additional security. This poses risks because in case of default, the banks would have no option than to fall on the assets to defray the debt. The risks associated with using the assets as collateral was a concern to stakeholders, but the participants indicated that due to the Director's interest and other caveats placed on the title during transfer the banks may have to inform them before taking over properties in case of default. In view of this, the property would revert to the state, which would then be responsible for the debt.

For example, in NSW there was an effort to enable CHPs to take out mortgage finance on transferred properties, even though the title specified a continuing government interest in the property. This was done by subordinating this interest to the financier, however the government would be notified if there was any default in payments on the mortgage. This suggests that the government could continue to manage repayment processes prior to default, to proactively manage risk.

This level of risk management has been less apparent in other jurisdictions. In Tasmania, the title transfer is done at full market value because in the event of a default, the value of the housing could be sold at full market value. While there is an encumbrance (i.e. a requirement that the housing be leased as social housing for 30 years), this could 'fall away' if there was a default by a CHP. Housing Tasmania would manage that risk with a buy back option.

4.7 Summary

There are a number of capital management practices and techniques that CHPs are using to manage new stock that is transferred. Some of these practices need to be adopted prior to the time of transaction (e.g. at time of tender) and continued over the course of the time these assets are managed by the CHPs. Different rights of control of the asset across the states – present different challenges.

Since most stock transfers have been management transfers only or asset transfers facilitated through limited term leases, the SHAs have continued to put conditions on the terms of asset transfer. Lack of title transfer will serve to constrain the ability of CHPs to borrow, however for most financiers it is cash flow that is the key issue to enable borrowing and financiers are able to calculate a value of assets derived from cash flow, and typically are able to lend between 20–30 per cent of the assets value.

Good techniques to ensure financial capital is conserved include using Interest Cover Ratios (ICRs) to estimate the risks that provider earnings can more than meet financing costs. In cases where assets were substantially transferred, SHAs were able to preserve the public interest by making provisions in cases of provider default, in some cases by provisions for bankers to notify the government ahead of default or making provision to buy back stock. Viability of providers will be assisted by ensuring stock transfers are of sufficient scale to enable large scale

providers to operate efficiently and spread overhead costs like tenancy management over a large number of dwellings.

Ability to redevelop properties is a critical power that CHPs need to manage physical capital. Some CHPs have also been required by governments in addition to make net increases to supply. CHPs, with SHA consent, can act to dispose of properties and use proceeds to invest in new stock, and therefore exercise some ability to manage and redevelop assets. CHPs, through due diligence processes, need to obtain accurate information about the stock they are acquiring, to know the maintenance and redevelopment burden and understand future requirements to redevelop and repair stock.

5 Processes and benefits of building condition assessment

5.1 Introduction

An important element in property transfer processes from the public housing sector to CHPs is to assess the condition of land, buildings and infrastructure being transferred.

State housing was predominantly built post WWII and new supply has been limited since the 1980s (Kenley, Heywood et al. 2011). This has meant that the profile of social housing has progressively aged. As a result, social housing requires significant maintenance. Wear and tear, lack of alignment of stock to need and functional obsolescence make for management and funding challenges.

Building condition assessment practices play an important role in transfer processes. Ultimately, advanced asset management practice informed by good asset data and appropriate benchmarking will allow tenants to be housed in a well-maintained and appropriate property, and to enjoy a good physical setting in the right location to meet their needs. Further, advanced asset management practice within the social housing context should allow for portfolio growth to occur in a financially sustainable manner to meet waiting list demand.

5.2 Potential issues with social housing asset features and property transfers

In property transfers, the condition of the asset must be factored into the operation of the CHP through maintenance forecasts, assessment of backlog costs and the asset condition the CHP accepts as the 'ideal home standard'. These factors impact cash flow projections and determine investment value. Issues which are currently widely canvassed and dealt with differently across jurisdictions and CHPs include:

- The commitment to ongoing capital and maintenance responsibilities without a full understanding of the commitment and expectations—this may result in no clear setting of benchmarks to measure maintenance condition or capital requirements for budgeting and reporting purposes.
- The lack of a national definition for a 'decent home' that incorporates: maintenance condition, functionally, energy efficiency, stock alignment.
- The scale of property transfers, and whether the transfer is by lease or title, is likely to determine the level of asset management resources, level of responsibility for maintenance and capital, and operating model and funding required. What are the different models of asset management created by scale, lease and title transfer?
- The understanding of capital allowances for renewal or new capital that create depreciation allowances by transferees.
- The systems and mechanisms that are in place to assess condition at transfer. Once the transfer occurs is there a transfer of asset data and is that data sufficient to allow advanced asset management practice to occur? If not, what systems are developed by the transferee to ensure advanced asset management decision-making can occur to ensure the financial sustainability of the portfolios?

For capital renewal items or new capital for major reconfiguration, the depreciation that is calculated will also feature in the forecast cash flows. Like maintenance costs, the understanding of the capital costs, timing of capital and the depreciation method needs to be fully understood by both parties in the transfer process.

5.3 What processes are used by public housing managers to manage assets?

State housing authorities have a responsibility to assess the physical condition of all their assets in order to manage these assets. These physical characteristics include building fabric, dwelling size, age, type, communal areas, land development capacity and dwelling location.

Asset management deals with the state of repair of assets, and considers strategically how they meet needs. As outlined in Section 1.1, governments are now concerned with leveraging assets to achieve wider community benefits such as:

- growth in overall supply of housing
- tenants enjoying well maintained property in good condition
- tenants enjoying an appropriate physical setting
- tenants enjoying appropriate residential locations.

A number of processes might be identified that are presently integral to public housing asset management:

- assessing the condition of buildings
- compliance schedules to maintain and repair
- processes to assess alignment of the stock with demand
- assessing functionality of the assets in relation to modern usage of housing.

Condition assessments

Institute of Public Works Engineering Australasia (IPWEA) and the National Asset Management Strategy committee (NAMS) specify a condition assessment methodology and asset planning processes through best practice guidelines. They also offer training and certification. In addition there is an international best practice standard and guide (ISO5500).

All SHAs have some form of condition assessment process for their assets. This is the precursor process to understand the timing of repairs and renewal work, and ultimately derive a backlog, current and projected cost estimate. For example:

- Tasmania uses 10 property amenity items that are given a condition rating of 1–5. A score of 1 indicates an urgent repair while a 5 indicates excellent condition.
- NSW housing has created the Property Assessment Survey (PAS) which uses a 1–10 scale.
- Queensland uses a Property Standards Index (PSI) which was developed in conjunction with Queensland University of Technology and the Commonwealth Scientific and Industrial Research Organisation (CSIRO).

Often a comprehensive maintenance contract provider carries out the assessments and provides that data to the SHAs.

Compliance schedules (asset management)

With most management transfers in Australia social housing authorities have responsibility for structural repairs, while CHPs will be responsible for repairs and maintenance. However, in

asset transfers, the maintenance requirement will comprise responsive, planned and backlog maintenance and in some cases structural work. In addition, for those properties transferred by title the CHPs will need to provide a plan for capital renewal. For example, in Victoria and South Australia the lease outsource model also includes a requirement to do structural work in addition to maintenance. The Asset Management Plan (AMP) will also deal with future development to grow the stock of housing since this is a clear objective of the transfer process, particularly title transfers.

The strategic asset management responsibilities are mixed, with South Australia requiring the CHP to have strategic asset management plans while Tasmania has a collaborative approach. The other states maintain the responsibility for strategic planning with the SHA. Interviews with CHPs indicate that the long-term strategic plan for the asset is important to know so that they can better plan their resources. Where the SHA is directing the strategic plan, then the interviewees advised they are wary of investing in additional maintenance costs in an asset where they may lose control. Where the CHP has more collaboration with SHA or control over the strategic management of the asset, they will be better placed to make decisions as to which upgrades are required, and where their resources are best allocated.

Once the tender has been awarded and the assets transferred either by lease or title, the successful CHP must develop an AMP that addresses the maintenance requirement.

In some cases a CHP has the advantage of being familiar with the condition of the assets within the portfolio. A two stage process, transfer by lease, then by title, is the preferred transfer method in Victoria in order to minimise tenant disruption. This process may include an option of access to the SHA's maintenance contractor. Alternately, they may opt to organise their own maintenance provider, which seems to work well in localised portfolios. In all transfer processes priority is given to ensuring that there is no disruption to essential services such as lifts and fire systems. Currently NSW are going through the tender process to transfer assets, and the terms of that tender require the successful CHP to use NSW head contractors until 2021.

Aligning stock to demand

In cases of asset transfers, CHPs will be empowered to make changes to stock profiles over time to ensure a better fit between stock and demand. This includes decisions to demolish and rebuild, package capital renewal work, defer lumpy expenditure, redevelop sites, retain and maintain, reconfigure, or sell and reinvest elsewhere. The use of standards and the audit of their use should enhance the level of asset oversight, custodianship leading to optimised decision-making.

Asset functionality

It is expected that CHPs, like SHAs before them, will over time make improvements to stock to address new expectations of functionality. If it is found that the standard from which those cost estimates were based is set too low, the result would inhibit the ability to grow the portfolio after the transfer occurs.

5.4 Key asset management issues faced by CHPs in tendering for stock

A social housing organisation taking on responsibility for managing stock must have the capacity (financial and institutional) to undertake these processes or they must be done by the state. The long-term viability of these organisations (and the willingness of financial institutions who back them) is dependent upon these organisations having sufficient cash flow to meet expenses and resource these processes.

They must also be able to plan into the future. Integral to this process is the accuracy of maintenance forecasts, backlog maintenance and depreciation to ensure their operation (and the investment backing it) is sustainable. Both of these things require an ability to manage uncertainty.

Equally important is the shared understanding by transferor and transferee of maintenance standards, shortfalls in maintenance, obligations, costs and contracting practices. When full title transfers are occurring, CHPs, in order to fulfil the tender contract obligations, need to be able to fully understand maintenance commitments, as well as structural, capital renewal and amenity gaps where these are applicable. If the transfer is by lease, then the tender obligations will not require full understanding of all asset-related matters such as capital renewal or structural aspects since these responsibilities typically remain the responsibility of the state.

Interview data suggested a few issues:

- concern over reliance on SHA condition data and lack of direct access to undertake assessments
- lack of consistent condition-rating systems between jurisdictions
- lack of consistent definition of functionality or stock alignment
- access to good systems and staffing for asset management
- lack of scale or concentration of assets.

Reliance on SHA condition data

From the interview process, it is clear that the building condition assessment is a critical element of asset management practice and forms the basic building block for advanced asset management practice. Good asset data leads to the creation of forecast maintenance requirements, current backlog maintenance, capital requirements and identification of non-compliance items. Without this information during the pre-tender submission process and the transfer process it becomes problematic for CHPs to develop confidence in feasibility projections for the purposes of tendering for the assets being transferred.

For all SHAs interviewed the due diligence process allowed for the transfer of asset data to CHPs that may be tendering for SHA assets. Among this information is data about the condition of the assets. The CHPs then assess this information and use it for the purposes of tendering for the assets being transferred. For practical reasons, such as cost and tenant disruption, CHPs are not able to conduct their own condition surveys prior to tender and must therefore rely on the SHA asset data and their own general knowledge and experience.

Lack of consistent methodologies for building condition

SHAs each have their own version of asset condition assessment. A criticism of this approach is that there is no consistency across Australian states. This causes interpretation issues for CHPs that may be tendering for, and operate, across different states. As a result, many CHPs employ their own systems and in some cases may convert the data provided in order to make it more consistent across states. For CHPs this issue may create difficulties during due diligence and after the stock transfer process. The lack of consistent methodologies adds costs and time to processes of tendering and management costs across jurisdictions. Aligned with this is inconsistency in training, certification, IT systems and audit processes.

It is also clear from the interviews that each state has developed their own system of condition assessment and standards over the course of time and that these systems are the result of a great investment of time and resources. Some, such as Queensland's Property Standards Index (PSI), are also protected by intellectual property. The dissemination of these data during the

tender process to CHPs becomes problematic due to the conversion process that needs to occur so that it becomes interpretable and meaningful.

It is also problematic for CHPs that operate within multiple states and need to interpret the many different condition assessment and standards of other states.

The interpretation and conversion process during the tender process involves significant time and expense without any guarantee of being the successful tenderer. Furthermore, where multiple parties are tendering they will have to conduct separate reviews of the condition of the assets. The level of condition data supplied needs to be supplied at the right component level at tender for the purposes of creating accurate budget requirements.

Similarly, since terms of contracts can also vary between states and vary whether the transfer is by lease or title, these will have different implications for the level of portfolio management by CHPs.

Standards for functionality and stock alignment

Defining standards of asset condition, functionality and stock alignment is complex. Themes such as ‘fit for purpose’, ‘energy efficient’, ‘healthy and safe’ and ‘functional’ often feature, but criteria for measurement and standards are difficult to define.

Maintaining good systems to plan asset management

Asset data, and software to analyse it, is critical to CHP asset management. Well-trained asset management staff are also important for financial sustainability. Asset staff within the CHPs tend to have a high turnover and there is a lack of specialised training in this field according to an asset management software supplier and consultant to CHPs.

Location and management

Where portfolios are geographically spread or in remote areas, higher costs are naturally encountered for maintenance costs, scoping of maintenance requirements and costs and quality assurance checking. In addition, the ability to meet responsive maintenance requirements in a timely manner can be compromised. CHPs with larger portfolios more concentrated in discrete local areas seem to be more favoured from a maintenance management and general portfolio management perspective.

5.5 Summary

Information about asset data, appropriate software to store and analyse asset data, asset management expertise and asset management techniques all impact on the ability to manage and optimise a portfolio. This is the case whether the assets are leased or owned, part-owned or whether the portfolio is owned or managed by an SHA or a CHP. However, the advantages of GST savings and access to the CRA mean that the not-for-profit housing sector has a greater opportunity to fund the portfolio’s assets condition and amenity gap requirements.

The quality, accuracy and interpretation of asset data at transfer, combined with the continuation of sound asset management practice post-transfer, is critical. Without this full oversight of the assets’ condition, amenity levels offered, the standard of physical setting and appropriate locations, then optimal portfolio creation and management will not be possible. Without this fundamental understanding of the assets and financial foresight that develops from that, the ability to transform the portfolios over time with sound financial stewardship is challenged.

States are happy with their own benchmarks in regard to condition assessments, but where CHPs act across state boundaries this causes difficulties. Larger CHPs use their own asset condition assessment software and condition ratings in order to attain greater consistency

across states. It would make sense for SHAs and CHPs to move toward a consistent means of condition rating and benchmarking, especially given the desire for more property transfers.

It is also argued that there should be consistency of condition standards from a tenant's perspective. For example if they are paying 25 per cent of their income on rent in Victoria or NSW they should expect the same level of amenity and condition in both states. Similarly, the Federal Government is also a stakeholder in this housing system through the provision of CRA. The Federal Government may also anticipate that the tenant is getting the same level of accommodation standard across Australia in response to their social support.

Fundamental to policy development at the federal and state government levels, is full knowledge of the extent of the financial liability to bridge current gaps in addressing backlog maintenance, future maintenance and capital requirements. Governments need to have faith in the housing standards and processes used to cost those liabilities.

At this stage, the objective of portfolio growth remains aspirational and capital works remain difficult to fund for some CHPs. The danger with capital renewal work not being undertaken is that it may lead to other component failure, further financial liability and ultimately a shorter lifecycle. Nevertheless, a well-managed portfolio will deliver optimised net revenue and asset value, thereby allowing leveraging to meet growth through new supply of community or affordable housing.

6 Conclusion

The Australian public housing transfer approach was based partly on lessons from international contexts. AHURI research into property transfers in the UK argues that successful transfers are not just about creating improved value for money for the public purse (although value of stock and improved maintenance are common motives for transfer) but also whether it leverages growth in the Community Housing Sector (Maclennan and Maio 2017).

The success of property transfer methodologies therefore relies on clarity about the policy objectives: objectives may include sector development, revenue maximisation, leveraging existing assets for additional growth, service improvement, and community benefit

Governments in Australia have mainly pursued transfers of management responsibilities. Few asset transfers have involved transfer of title, but effective asset transfer has occurred in places like NSW through a 20-year lease arrangement which enables assets to be recorded as 'disposals' on the public accounts.

This study has looked at transfers with a particular focus on the legal, valuation and condition assessment practices of housing being transferred in the context of their implications for capital and asset management practices.

Legal issues

Legal issues may encumber the value of assets managed (for both management and asset transfers). This includes:

- costs CHPs must bear in relation to tenancy management
- the requirement to provide ongoing affordability and secure housing to tenants, and restrictions on capacity to sell assets to other parties at market value
- whether leases are effectively transferred to CHP control in cases of management transfer (thereby enabling the CHP to receive rental and CRA revenues)
- whether tenants have rights to choose their landlord (and potentially impact CHP revenues through CRA)
- what costs CHPs must bear in relation to repairs, maintenance and expectations of future housing supply
- the length of the lease transferred to CHPs and the rights or encumbrances attached to that lease
- whether the arrangements prove to be overly complex.

In asset transfers, the value will also depend on whether the state retains an interest in any proceeds from sale, costs of maintenance and what occurs in cases of default.

Valuation

In Australia, there are relevant standards for valuation which are drawn from international standards and these are the remit of the Valuer-General in each state. The adopted valuation methods are set out through standards and procedures under the International Valuation Standards (2013) and then transferred into practice through the Australia and New Zealand Valuation Standards (API 2013). These standards are complemented with the *Valuation of Land Act*, which is state specific, and determines the valuation process for government-owned assets.

In Australia, there are generally four valuation methods, namely:

1. market comparison

2. cost approach
3. income capitalisation
4. residual method of valuation (API 2015).

While the market comparison approach is the most widely used method for valuation of property transfers in Australia, at present there is no consensus on the type of value that must be reported for assets held by State Housing Authorities (SHAs) in Australia in relation to market value.

However, income is also relevant for many Australian transfers involving leasehold rather than title because for debt raised on a lease the cash flow is the critical component, rather than the asset value. The lease term is also important for the creation of the debt, as the financiers' security will only extend as long as the lease term. In the lease scenario, any reduction in generated income through lowering of rents, or reduction in CRA, will have a significant impact on the borrowing capacity.

Case studies in this research show that the market comparison valuation method will provide much higher values for housing transferred, and therefore provide much greater capacity to borrow against that asset. By contrast, income methods of valuation, because they reflect lower cash flow, will result in lower valuations and therefore lower capacity to borrow.

This has implications for the realisation of a value for CHPs wishing to borrow against the asset.

The value of the asset to the CHPs will also depend on the outcomes, such as community benefit, sought by governments. These outcomes include:

- increasing the supply of housing—it is hoped that transfer of public housing to CHPs would achieve the goals of increasing supply of housing
- increasing services and operational efficiencies
- empowering tenants, and leading to place management and community renewal
- ensuring good quality housing—well maintained and in good condition and in an appropriate setting and location.

There is also particular concern in valuing special purpose housing where the costs of alterations and design modifications are likely to exceed any additional value placed on the asset.

Optimal capital management practices

Optimising capital management will involve managing risks effectively—this is done by anticipating costs and revenue and potential risks associated with stock. CHPs will also improve their capital management if they can; access debt capital (which will enable them to replace existing ageing stock or expand), access the maximum subsidy available through CRA to increase cash flows, and make sure that both at the time of tender and after, asset conditions and valuations are realistically assessed.

Optimal capital management practices for governments include:

- clear purpose and objectives
- the use of tender processes
- the use of concurrent leases to simplify the transfer of tenancy service obligations
- consistency of valuation
- accurate records on condition
- that all SHAs and CHPs adopt a common property standard that is kept updated

- contractual arrangements that agree what community benefits and tenancy management outcomes are required.

Managing risks around provider default will also be important. Good techniques to ensure financial capital is conserved include using Interest Cover Ratios (ICRs) to estimate the risks that provider earnings can more than meet financing costs. Ensuring legal arrangements are clear will also provide comfort for both investors and CHPs. For example, in cases where assets are substantially transferred, agreements involve legal provisions for bankers to notify the government ahead of default or making provision to buy back stock.

Viability of providers will be assisted by ensuring stock transfers are of sufficient scale to enable large-scale providers to operate efficiently and spread overhead costs like tenancy management over a large number of dwellings. Ability to redevelop properties is also critical in managing physical capital. CHPs, with SHA consent, should be able to act to dispose of properties and use proceeds to invest in new stock, and therefore exercise some ability to manage and redevelop assets.

Property condition assessment

There is an international standard and best practice standards and guidelines which provide condition assessment methodologies and asset planning processes. There is inconsistency across states, and it would make sense for SHAs and CHPs to move toward a consistent means of condition rating and benchmarking, especially given the desire for more stock transfers.

Fundamental to policy development at the federal and state government levels, is full knowledge of the extent of the financial liability in addressing backlog maintenance, future maintenance and capital requirements. CHPs and governments need to have faith in the housing standard and processes used to cost those liabilities.

Conclusion

This research finds that there is evidence of change in property transfer methodologies and that the approaches across states are evolving. CHPs can most maximise their borrowing and therefore growth capacity by pursuing transfers of assets (rather than just management transfers).

Quite apart from the risks around uncertainty in processes and valuation techniques, a major challenge for organisations engaged in property transfers is that there is considerable change in the political, policy and economic circumstances affecting their processes. The 2017 Federal Budget and, if implemented, the recommendations of the recent Productivity Commission report into Human Services, are likely to place more emphasis on growth through new supply than through property transfers.

This research identified several forms of risk that need to be identified by all transaction parties for each transfer, since each situation will be different. Some of these risks (economic and political) are difficult to address but need to be considered by CHPs entering into transfers. Even so, governments can do more to de-risk processes by increasing standardisation of valuation and property maintenance, as well as encouraging best practice around capital management techniques.

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Appendix 1: Context to social housing transfers in Australia and overseas

Social housing background

Public housing in Australia has existed since the early twentieth century. The foundations for the present system were established in the mid-1940s when the newly formed Commonwealth Housing Commission (CHC) recommended that the government take an active role in reducing a severe shortage of housing (Yates 2013).

Since 1945, social housing in Australia has been developed, owned and managed largely by state/territory governments, traditionally known as state housing authorities (SHAs) (Pawson, Milligan et al. 2013: 9). Social housing today includes public housing, community housing, as well as state-owned and managed Aboriginal and Torres Strait Islander housing. In 2016, more than 427,700 dwellings provided housing, usually at below-market rents, to low-income households and those with special needs (AIHW 2016b). Rent is highly subsidised (generally set at 25 or 30% of household income) and is determined by tenant income (Yates 2013).

Demand for social housing

Home ownership in Australia is increasingly unaffordable for low-income and younger Australians (National Housing Supply Council 2012). In particular, over the past decade there have been large increases in residential property values, and slow development of well-targeted affordable housing. There is not enough affordable private rental housing for low to moderate income households. This is most evident in Sydney, Melbourne and Brisbane. For example, in Sydney there is one affordable and available rental property for every 15 very low-income households (AIHW 2014: 3).

The social housing sector is increasingly under pressure to assist more households to access appropriate and secure dwellings. Current demand for social housing is much higher than supply, and waiting lists and times are extensive. For example, as of June 2013, nearly 160,000 people were on public housing waiting lists nationwide (Department of the Prime Minister and Cabinet 2014: 20), and in Queensland a shortfall of 83,000 dwellings was identified (Kraatz, Mitchell et al. 2015).

Social housing shortage

Consistent with the economic and social management agenda of federal governments over time, direct housing provision has declined since the 1980s. Housing allowances through Commonwealth Rent Assistance (CRA) outstripped social housing expenditure by 1998, with the gap widening to the extent that in 2008, CRA expenditure was twice social housing expenditure (Groenhart and Burke 2014: 130). As capital funding declined, the total stock of housing failed to keep pace with demand. The share of social housing in the total housing stock dropped from a peak of a little over six per cent at the start of the 1990s, to a 50-year low of a little over four per cent by 2008 (Yates 2013: 115). Limited available capital funds were used to cover maintenance backlogs arising from operating deficits.

The community housing sector

Until the 1990s, community housing was characterised by small, NFP providers catering to niche markets (e.g. Catholic community), until changes in funding from the early 1990s expanded the sector. By 2008, mainstream community housing represented a little more than 10 per cent of the total social housing stock (Yates 2013: 116). During the 2000s the sector grew due to its ability to access CRA, not having to pay Goods and Services Tax (GST), and being able to borrow on the open finance market (all not available to public housing). This

meant that CHPs could leverage more new development for a given dollar than if the money was spent on public housing.

Drivers behind the stock transfer policy

In Australia, the transfer of stock from public housing providers to community housing providers was, for a while, the preferred policy tool of state and federal governments (Gough 2013). According to Pawson, Milligan et al. (2013: 2), there are two main objectives for the stock transfer policy, beyond an overarching aspiration to diversify social housing through an expanded community housing sector. The first aim is to address supply issues and increase the stock of social housing in a financially viable way. This will enable CHPs to leverage their assets and seek finance to build more stock, which is something that governments appear to be unwilling to do. The second aim is to address the structural financial deficit that is a result of the growing gap between rental revenue and the costs of running the portfolio (Victorian Government 2012: 32). Interestingly, CHPs have had access to funding avenues that are not available to government, such as Federal Government tax subsidies, philanthropic donations and CRA (Gough 2013).

In addition, other distinct policy objectives for stock transfer include (Pawson, Milligan et al. 2013: 2–3):

1. Service improvement and better operational efficiency, which are expected to occur as a result of transferring public housing to CHPs with larger CHP portfolios.
2. Tenant and community empowerment, which has been a relatively weak driver in the Australian context, in contrast with the UK.
3. Place management and community renewal which, based on the Queensland, South Australian and Tasmanian initiatives, may become important drivers in the future.

Interestingly, Pawson, Mullins et al. (2010: 62) provide a disaggregation of motivation by stakeholder type. Although beyond the scope of this report it provides an interesting perspective that seems to be broadly consistent with the discussions held through this research.

Housing stock transfers

In a discussion paper (KPMG 2012), which focused on how to improve the supply of quality social housing in Victoria, three public housing transfer models were identified. Each involved the transfer to the non-government sector of responsibilities related to the ownership, management, and/or operation of the public housing stock. These include:

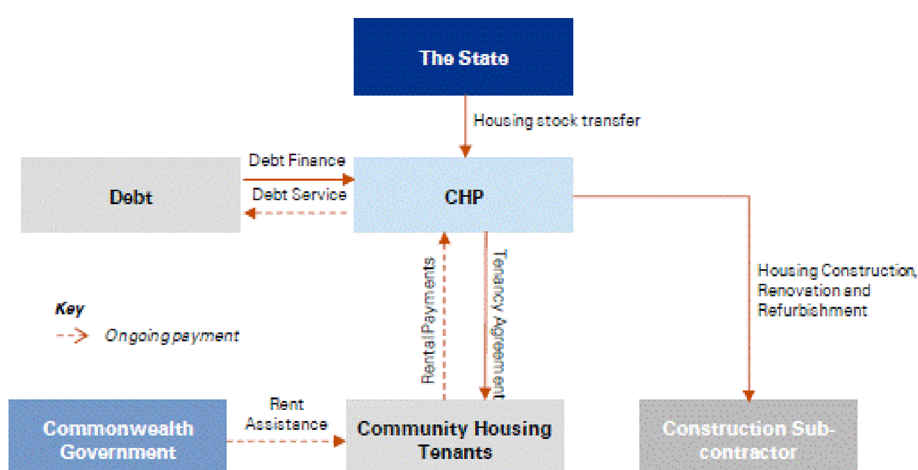
1. Community housing stock transfer model—transferring legal right and other rights/responsibilities over state housing stock to the CHPs.
2. Shared equity/ownership schemes—involves tenants purchasing a minimum share of the property with ownership of the remaining share of the property being retained by the state and or a CHP.
3. Outsourcing of maintenance/management—the private sector delivers tenancy, relocation, communication, consultation, community renewal and other services to public housing tenants and other community members.

Here we discuss only two of the three options stated (1 and 3), involving transfer of title/asset or management outsourcing to CHPs, and not to tenants.

Asset/title transfers

Asset/title transfer involves the transfer of the dwelling ownership to a community agency for use as social housing. Title transfers can generate financial advantage through leveraged private finance, secured against the transferred asset and repaid through projected rental income stream. Greater CHPs' independence could maximise entrepreneurialism and innovation, and may bring more responsible, rational and efficient long-term asset management planning (Pawson and Wiesel 2014). See Figure A1 below for the commercial structure of the asset stock transfer model.

Figure A 1: Commercial structure of the CHP stock transfer model



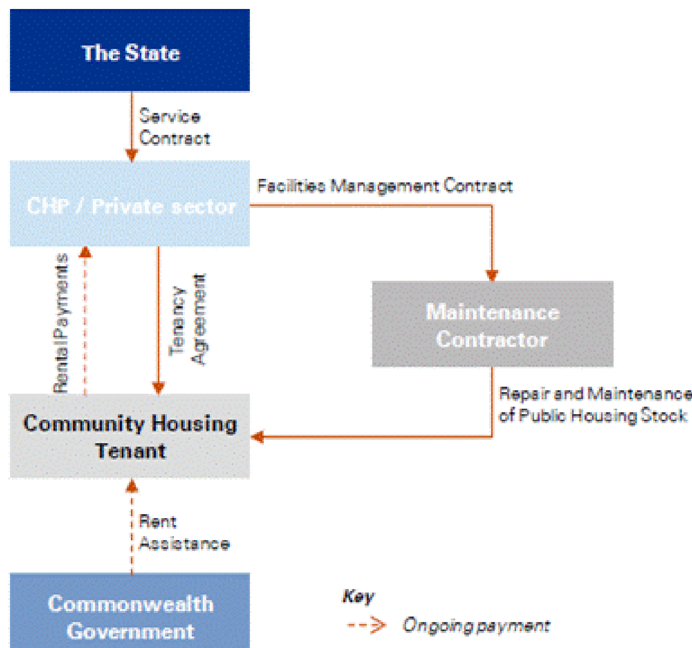
Source: KPMG (2012: 45).

Management outsourcing

Management outsourcing involves the transfer of tenancy from the public sector to a community agency. Management is contractually delegated to a CHP for social housing use (Pawson and Wiesel 2014). In Australia, apart from some asset transfers, transfers to date have mainly been confined to management outsourcing.

Of all the housing transfers in Australia by 2013, 72 per cent (about 15,000) were management transfers and 28 per cent (about 6,000) title transfers. Most housing transfers have involved handovers to existing CHPs (and not to new entities set up specifically for the purpose of receiving transferred assets as predominated in the UK), although the Aboriginal Housing Victoria (AHV) case involved negotiated restructuring and significant capacity building in the successor landlord agency (Pawson, Milligan et al. 2013: 3). See Figure A2 below for the commercial structure of the management outsourcing model.

Figure A 2: Commercial structure of the CHP management outsourcing model



Source: KPMG (2012: 56).

International housing stock transfer practice

Australian public housing transfers policy can draw from countries that have seen a large shift in public housing from municipal control to community housing schemes with NFP ownership landlords. To achieve public housing transfers on a substantial scale, the research examines countries where government policies provided the platform for the growth of community housing schemes. These include transfer experiences in the UK, the Netherlands and the US.

UK's experience of housing stock transfer

Over the past two decades, the UK social housing sector[5] has undergone a fundamental change. As a result, there is currently a well-defined social housing sector where the traditional social housing sector in the hands of public authorities has been cut down from 93 per cent in 1981 to just 29 per cent in 2008 (Pawson, Mullins et al. 2010). This operates alongside registered social landlords (RSLs) that are non-profit organisations also delivering social housing services on behalf of the government. In effect, through the restructuring process, the UK has succeeded in ending the public sector control of social housing by taking it from the hands of about 180 councils and creating over 300 new RSLs (Pawson, Mullins et al. 2010).

Generally, the objectives of stock transfer in the UK have been based on revenue maximisation, leveraging private finance for new supply, operational efficiency, tenancy service improvement, leveraging private finance for stock upgrade, tenant/community empowerment and enhanced long-term asset management (Pawson, Milligan et al. 2013). This process of stock transfer has so far covered some 1.5 million dwellings (Pawson and Wilcox 2013). In the process of stock transfer, several strategies have been used by different councils in the UK, depending on the

[5] As in Australia, the term social housing in the UK indicates public housing owned by the state, as well as other community housing.

size of the stock to be transferred. Based on the UK experience, Malpass and Mullins (2002) observed two main effects relating to restrictions on rent levels and the restricted access to housing by the deserving tenants selected by social landlords after the transfer. Nonetheless, the stock transfer process has resulted in the development of a financially strong social housing structure which has expanded through a blend of reinvestments into the social housing sector, new construction and the ownership transfer of tenanted housing.

Netherlands' experience of housing stock transfer

The social housing sector in the Netherlands, which is made up of social housing associations providing housing for vulnerable groups, has also undergone restructuring but different from the UK experience. Through the Netherlands' restructuring process, social housing associations have metamorphosed into autonomous NFP organisations functioning as providers of public goods and services. These services are provided in exchange for financial and legal privileges allocated by the Dutch Government (Blessing 2012).

Currently, there is still a considerable number of properties under the ownership of social housing associations (serving both low and middle-income earners). There are also other private properties that are rented to low-income earners and as such fall under the regulated social rental sector. Through the restructuring process, the stock under the control of SHAs has been reduced drastically. Statistics show that in 2009 the total housing stock consisted of 55 per cent owner-occupied housing, 32 per cent social rented housing and 13 per cent commercial rented housing (Priemus 2010), as opposed to a larger chunk of social housing in the 1980s. The proportion of 32 per cent of social rented housing sector still accounts for a larger proportion of the housing stock in the Netherlands compared with all other European countries (Pittini and Laino 2011; Whitehead and Scanlon 2007). This shows the strong position of the social housing associations even after the transfer of some of the dwellings to sitting tenants.

This hybrid system of operation has made the housing associations stronger and competitive and is able to increase the stock of dwellings without recourse to the government. The hybrid model ensures profitability of social housing associations and an improvement in the maintenance and upkeep of the properties.

USA's experience of housing stock transfer

The public housing program in the US was initially a public endeavour involving federal, state, and local governments in an attempt to provide decent and affordable housing to low-income earners. This was enshrined in the first large-scale oriented *Housing Act 1937*, as the Act required state or local authorities to be responsible for owning, building, and maintaining public housing through the establishment of local public housing agencies to manage the housing program. However, in 1973 the expansion of the housing program was halted due to concerns over funding for the program (Hackworth 2005). As a result, there was a substantial cut in funding to these public housing agencies. The resultant effect was an increased decentralisation of public housing to give the local authorities more control over public housing in their localities. Just like any other privatisation, the main idea behind it was to promote greater individual autonomy, reliance on the market mechanism, and less state intervention in the delivery of housing.

As a result of the substantial reduction in funding from the Federal Government for housing, several of the local public housing agencies have become social entrepreneurs in order to keep their existing housing stock and to add more dwellings (Nguyen, Rohe et al. 2012). In this way, the local public housing agencies are able to engage in market-oriented economic activities while at the same time providing goods and services that serve social purpose as social entrepreneurs (Czischke, Gruis et al. 2010). The market-oriented activities undertaken through

social enterprises in the public housing sector also promotes greater efficiency and innovation in the delivery of public goods and services (Kerlin 2010).

Australian stock transfer experience

The provision of public housing (affordable housing) is critical to the development of Australia in ensuring that the damaging social consequences of unaffordable housing can be avoided. However, many public housing dwellings in Australia are fundamentally rundown buildings due to the severely underfunded nature of the agencies managing them. The lack of funding has placed a substantial burden on state housing authorities/agencies (SHAs) to establish other forms of housing provision either in the private sector or through the non-profit sector (Jacobs, Marston et al. 2004). As a result, funding for SHAs currently comes from ongoing sale of some of the assets and deferral of essential upgrading and maintenance works (Berry, Whitehead et al. 2006). Due to these problems of underfunding leading to dilapidation, the new trend emerging is partly the attempt by the Federal Government to transfer tenancies and tenanted properties to NFP's housing organisations to both manage and develop new dwellings (Pawson and Wiesel 2014).

Milligan, Gurran et al. (2009) suggest that, since 2007, there is general consensus that the construction and development of new dwellings for the public housing sector must be through NFP community housing providers rather than through the use of local authorities in the form of large-scale developments as assumed by the SHAs in the past. This was evident in both the National Rental Affordability Scheme (NRAS) and the target of Canberra to achieve about 75 per cent additional social housing through the transfer of economic stimulus packages to the NFPs to manage (Milligan, Gurran et al. 2009).

Since 2009, the government has followed through with a target of restructuring the public housing sector to an extent that the CHPs (NFP) will control about 35 per cent of all public housing by 2014 (Housing Ministers Council 2009). Such a huge target obviously requires the deployment of large scale transfer of stock of assets from the SHAs to the CHPs for management and development. Interestingly, only one study has been conducted assessing the outcome of the target set in 2009, that being Pawson, Martin et al. (2016).

Prior to 2012, the transfer of Australian public housing dwellings had been carried out on a limited basis, but official announcements by some state governments give an indication that the transfer of public housing properties may be up-scaled in the future. This is due to strong federal and state governments' commitments to expand the provision of affordable housing largely through the use of the NFPs (Milligan, Gurran et al. 2009). This is also reinforced by expectations that large-scale stock transfers will be implemented in support of achieving this objective (Spiller and Lennon 2009). For example, Victoria announced in February 2017, that $1 billion will be invested into a fund for increasing social housing stock along with a fund to assist CHPs with low interest loans to assist with funding expansion of stock. In addition, the management of 4,000 properties will be transferred from the SHA to CHPs.

NSW holds the largest volume of public housing with around 144,000 social housing properties. At the time of completing this report, NSW have just released a tender for the management of 18,000 properties to be transferred to CHPs.

This research has concentrated on information obtained from four Australian states: NSW, Tasmania, Victoria, and South Australia. Each state has been recently involved in the transfer of stock, either through leasing arrangements or transfer of title. NSW has recently released a tender for approximately 18,000 properties on a 20-year lease arrangement. Victoria has just announced a lease transfer of 4,000 properties. The details related to that proposed transfer have not been released at the time of writing this report. This section highlights lessons learnt and pulls together 'good practice' for the transfer process.

As further background, each state has undergone transfer of title, or management/lease transfer within the last five years. NSW has the largest portfolio and has also transferred the largest volume of stock. Tasmania has recently transferred leases for 4,000 properties and is looking to convert some of these properties into a transfer of title. South Australia has transferred approximately 1,000 properties with a further 4,000 underway. The initial 1,000 properties were on a three-year lease, however the subsequent 4,000 are on a 20-year lease. Both states carried out a pilot run, prior to issuing their major stock tender. Victoria has transferred smaller lease numbers, but has also recently transferred approximately 1,500 titles to Aboriginal Housing Victoria. Victoria also announced in February 2017, under its Homes for Victoria plan, a proposal to transfer an additional 4,000 properties to CHPs.

The current tender process in NSW is using a 20-year concurrent lease, which is the same structure as South Australia, however both states have previously had much shorter lease terms of three years. Tasmania has a lease term of 10 years with a further 10 years renewal at the discretion of DHHS. The use of longer term leases will create a lessee interest in the asset that did not occur under the three-year short-term leases.

In Tasmania, a small number of vacant land titles were transferred as part of the tender process which was to enable the CHP to develop the portfolio. In the first transfer, 20 properties were identified which could be sold by the SHA and the proceeds kept by the CHP were to be used to further develop and improve the portfolio. In the main round with 4,000 properties, the CHP shares 50/50 of the sale proceeds with the SHA.

In South Australia, a strategic approach was taken to support and enable the CHP to expand the stock by either new developments or redevelopment on the existing site. High land yield sites were included, which tended to be in the more desirable neighbourhoods closer to the CBD. These sites have tended to be underdeveloped. With a business case to the SHA, the CHP is able to develop them and therefore improve quality of stock as well as expand the portfolio.

Transfer of title/lease

There appears to have been very limited transfer of title of public housing, rather, the approach being applied by the various states is either transfer of management agreements or leases. As part of all of these processes, including title transfer, the SHA ensures in the majority of cases, that the Director of Housing retains an interest on the certificate of title. This allows control of the properties to remain ultimately with the SHA. Some contractual arrangements with CHPs may allow for the redevelopment of existing public housing stock or the development of new social or affordable housing. A business case is put forward by the CHP to the SHA outlining the proposal for any sale of property and redevelopment.

A two-stage process, transfer by lease, then by title, appears to be the preferred transfer method by SHAs, in order to minimise tenant disruption. This process also provides the SHA with confidence that the CHP is able to manage the stock as well as provide the expected key objectives related to community benefits.

International and Australian stock transfer experiences summary

In summary, for the key public housing stock transfer stakeholders (government and housing providers), in the UK, there has been direct transfer of the stock of dwellings to non-profit organisations known as registered social landlords to develop, manage and maintain affordable social housing for vulnerable groups through market approaches. In contrast, the US and Netherlands experience includes the change of status of the local public housing agencies to social enterprises which then adopt a market-oriented approach to managing these dwellings. While in the Netherlands these social enterprises do not receive funding from the state to

develop and invest in their dwellings, in the US local public housing agencies' NFPs still attract funding from the public. However, they are both autonomous and use market-oriented approaches to manage and develop the stock of dwellings under their control.

In all three countries, many private organisations are also encouraged in one way or another to provide affordable housing to vulnerable groups through the provision of incentives such as the low-income housing tax credits in the US. Currently, these countries provide support in the form of housing allowances or assistance to those in vulnerable groups based on criteria ranging from earning an income below a certain threshold per year to being unemployed.

In a broad context, public housing transfer international models have many distinctive features (e.g. major government policy initiatives), separate from the Australian experience having substantially contrasting constitutional and legal frameworks. Therefore, it is recognised that international comparisons should be taken with caution. However, international housing stock transfer processes can highlight important aspects, which may be relevant at various stages of the Australian public housing transfer process. Currently, there are aspects of the UK experience that have a strong resemblance to the Australian stock transfer process.

In Australia, the Federal Government has adopted the stock transfer approach in an attempt to transfer the state's responsibility of providing housing to NFPs, primarily due to the benefits associated with the stock transfer. Currently, there is broad consensus that the stock transfer should be up-scaled in Australia to achieve specific targets set by the Federal Government.

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