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Debt Service Coverage Ratio 'Plus': Mitigating Property Finance Risk Through Non-DSCR mechanisms

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The Context.

When lending on property transactions, banks typically require a Debt Service Coverage Ratio (DSCR) of 1.2. What this means is that the borrower will need to show the bank that, in each year, it has a 20% buffer over and above the projected principal and interest costs.

Banks need this to protect themselves from the risk that the borrower's operating environment will be less favourable than projected. This could happen through:

- Revenues (rent) being lower than projected;
- Operating costs (rates, maintenance, insurance) being higher than projected; or,
- Financing costs (interest rates) being higher than projected.

By in large this is a fair and reasonable position.

What this means is that the borrower must arrange its affairs to have an annual surplus. If things don't go as expected, it can use this surplus to cover its operating shortfall, ensuring the bank can still be paid its interest and principal repayments.

To have an annual surplus borrowers have a few options. They can;

- Sell off some of the homes in their development (instead of holding them). This reduces debt and therefore debt service requirements.
- They can contribute more equity of their own, again reducing the required level of debt and debt service; or,
- In the case of Community Housing Providers (CHPs), they can increase net revenues by either:
  - not discounting rents (when providing affordable housing) or
  - decreasing expenditure on wrap-around services.

For CHPs, all four of these options have significant social implications. Selling homes to market means less opportunity for social/affordable housing. Contributing equity has an opportunity cost of funding other programmes or projects, increasing rents takes money from the pockets of those that need it most and scaling back wrap-around services reduces the potential to address the root causes of poverty for those CHPs are providing homes to.

While we understand the need for a DSCR buffer, we are also frustrated by the inefficiency of holding an additional 20% of reserves to the side.

What if there was a way to meet the assurance needs of banks whilst not selling down homes, committing additional equity, keeping rents as low as possible and continuing to provide wrap-around services?

A scenario.

A CHP has a proposed $20m development, looking to provide 25 homes to families on the social housing waitlist.

It owns the $4m land parcel and the government has agreed to capitalise $3m of its Operating Supplement so that the CHP has sufficient equity to get the Loan to Value Ratio (LVR) to 0.65.

It has an Income Related Rent Subsidy (IRRS) agreement with the government to ensure it gets market rents for its social housing tenants for 15 years.

These factors result in an DSCR of 1.15 but the bank requires the CHP to contribute $2m of its own reserves to reduce the level of debt from $13m to $11m which would bring the DSCR up to the 1.2 threshold.

The difference in cashflow to raise the 1.15 DSCR to 1.2 is approximately $90,000 in Year 1, $60,000 in Year 2 and $30,000 in Year 3 (the DSCR reaches 1.2 in Year 4 as rents increase in line with inflation).

The CHP had this $2m earmarked for another housing project which would provide homes for another 18 families. Due to the bank's DSCR requirements, the project now has to be deferred, leaving these 18 families in a motel (with significant adverse social outcomes and substantial costs to the taxpayer).

A solution.

The CHP approaches a charitable Foundation to see if they can provide the $2m on a low interest and no repayments basis for a five year term. It is projected that after this time they will be able to start repaying this loan.

The Foundation has another idea.

What if the Foundation set aside $180,000 as an effective guarantee over the first three years of the CHP's "DSCR deficit"?

This way the bank would know that if they needed to call on these funds (if expenses were higher than projected or revenues lower) then they were available.

The funds could be deposited with the CHP's bank, earning the Foundation interest and providing the bank with assurance that they can draw on these funds as required.

If the Foundation's funds were needed, interest would start occurring for the CHP and would be repaid when CHP cashflow allowed.

After Year 1, the reserve fund could drop by $90,000, leaving just the required funds for Years 2 and 3.

Further, the CHP could use its operating surplus from Year 1 to swap out the Foundation's funds for their own. This could drop the Foundation's commitment from three years to one, enabling it to recycle its own capital to other worthy projects.

Through this approach;

- the bank has assurance it's debt will be serviced;
- the CHP doesn't need to use its reserves to make the deal bankable;
- The Foundation enables the social outcomes from the second project to occur at a very low financial contribution.

Who is Gemelli?

Gemelli provides financial feasibility and business case advisory services to impact-based and social enterprise clients. We operate across the spectrum of for-profit through to charity by specialising in developing commercial strategies to help unlock social, economic, environmental and/or cultural returns. In the housing sector this sees us assisting Community Housing Providers, faith-based groups and Impact Investors as they explore investing in transitional, social, affordable, shared-equity, rent-to-buy and mixed-use developments (as well as rent-to-buy 'plus').

Gemelli lives out what it talks about: it is also a social enterprise, with 100% of its profits being distributed to Habitat for Humanity (to build homes in Nepal) and KidsCan (to help provide warm clothing and meals to schools in need).

James founded Gemelli in 2017 after a decade working in international development and project finance, followed by time at PwC and then joining the recovery effort after the 2010/2011 Canterbury Earthquakes. He is passionate about innovative uses of capital and commerce to alleviate poverty and to deliver environmental and economic impact.