# Financing First Nations' Participation in Major Projects

## CASE STUDY FOR LEARNING MODULE #1

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# Establishing Feasibility



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# **Project Finance Case Study:** Developing a rental property

## A landowner wishes to build a rental property to generate revenue and must first evaluate economic feasibility.

Economic feasibility analysis must consider sources and uses of funds over the life of the project and demonstrate that project revenues (**sources**) are sufficient to sustain operations and provide an attractive investment opportunity to project owners (**uses**).

### CONSTRUCTION PHASE
Sources and Uses

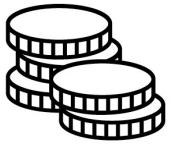
| SOURCES | USES |
|---|---|
| Owner's Equity | Design and Construction costs |
| Construction Loan | Inflation |
| | Financing Fees |
| | Interest during Construction |

### OPERATIONS PHASE
Sources and Uses

| SOURCES | USES |
|---|---|
| Rental Income | Operating Expenses |
| | Capital Expenditures |
| | Debt Services |

# Establishing Feasibility Construction Phase Sources and Uses of Funds

## CONSTRUCTION PHASE **SOURCES** OF FUNDS



The owner has $150,000 in savings available for contribution to this opportunity. This is the owner's equity investment. — $150,000

A lender will provide a $350,000 construction loan, repayable within 90 days after construction is complete. — $350,000

- Lenders will often allow for total borrowing to include:
  - Cost of interest during construction and — $6,000
  - Cost of financing fees. — $6,000
- Lenders often also allow for inflation costs of the construction materials & labor, or cost overruns. — $6,000

**Total Sources of Funds – Construction Phase** — **$518,000**

# Establishing Feasibility Construction Phase Sources and Uses of Funds

## CONSTRUCTION PHASE **USES** OF FUNDS

| | |
|---|---|
| The owner has received a design & construction estimate of $500,000 for the home | $500,000 |
| Design & construction costs, along with materials and labor are subject to inflation | $6,000 |
| The owner will need to borrow $350,000 of the $500,000 design & construction cost, so there will be: | |
| ▪ Interest fees on the loan during construction | $6,000 |
| ▪ Fees, like arrangement and commitment fees | $6,000 |
| **Total Uses of Funds – Construction Phase** | **$518,000** |

# Establishing Feasibility Construction Phase Sources and Uses of Funds

Matching Construction Phase sources and uses demonstrates that the owner has a plan to finance construction costs.

## CONSTRUCTION PHASE SOURCES AND USES

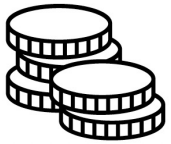
| SOURCES | | USES | |
|---|---|---|---|
| Owner's Equity | $150,000 | Design and Construction costs | $500,000 |
| Construction Loan | $368,000 | Inflation | $6,000 |
| | | Financing Fees | $6,000 |
| | | Interest during Construction | $6,000 |
| **Total Sources** | **$518,000** | **Total Uses** | **$518,000** |

Following construction, the owner has a $368,000 construction loan to repay (debt) and $150,000 of their own cash (equity) invested in the project. We have not yet validated economic feasibility.

To establish economic feasibility, the operations phase sources and uses of funds should demonstrate sustainable operations, and repayment of both debt and equity (including return on equity).

# Establishing Feasibility Operations Phase Sources and Uses of Funds

## OPERATIONS PHASE **SOURCES** OF FUNDS



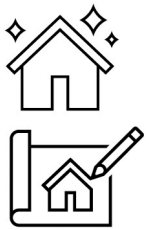
Rental revenue is the sole source of income from operations of a rental home asset.

- A lease is signed with rental rate of $2,750 / month
  - This equals $33,000 / year
- Rental rates escalate at 2% per year to reflect inflation
- The lease term is 30 years
  - In year 30, the inflation-adjusted rental rate is $58,000

**Total sources of funds –30 years of rental revenue** **$1,339,000**

# Establishing Feasibility Operations Phase Sources and Uses of Funds

## OPERATIONS PHASE **USES** OF FUNDS

| | |
|---|---|
|  | A bank appraises the built home at $600,000 |
| | ▪ The owner chooses a 70% mortgage — $420,000 |
| | ▪ ▪ Refinance construction loan, take out some equity |
| | ▪ The mortgage will carry interest payments — $211,000 |
|  | The house, when built, will require 30 years of ongoing operating expenses to remain fully functional — $243,000 |
| | Plus routine and occasional major maintenance — $32,000 |
|  | Since it is a rental property, maintaining a small cash reserve is also a good practice — $5,000 |
|  | Equity distributions to the owner following debt and operations obligations — $428,000 |
|  | **Total Uses of Funds – Operations Phase** — **$1,339,000** |

# Establishing Feasibility Operations Phase Sources and Uses of Funds

For the operations phase, matching the sources and uses of funds including all operational obligations, debt repayment and equity returns, demonstrates economic viability over the long term.

## OPERATIONS PHASE SOURCES AND USES

| SOURCES | | USES | |
|---|---|---|---|
| Rental Income | $1,339,000 | Mortgage Principal | $420,000 |
| | | Mortgage Interest | $211,000 |
| | | Operating Expense | $243,000 |
| | | Maintenance | $32,000 |
| | | Reserve | $5,000 |
| | | Equity Distributions | $428,000 |
| **Total Sources** | **$1,339,000** | **Total Uses** | **$1,339,000** |

The owner uses the $420,000 mortgage to pay the $368,000 construction loan. The remaining $52,000 is an 'equity take-out' for the owner. Rental revenues are sufficient to pay the owner $428,000 in equity distributions over 25 years, which is a 7.11% annual return on equity.

SECTION 2

# Construction Phase



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# Key Assumptions and concepts to understand about the Construction Phase

It takes twelve months to construct the house.

Equity is the 'first-in' capital, and will be used to cover construction costs before debt is drawn

In addition to interest expense, lenders will charge 1% of the $368,000 committed amount as arrangement fee and 1% of the undrawn balance as commitment fee.

Construction delays and cost overrun will accrue to the owner, and result in a more costly project. The owner should have a contingency.

SECTION 3

# Operations Phase



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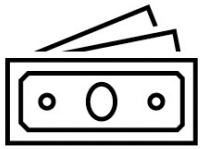
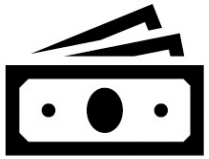
# Key Assumptions and concepts to understand about the Operations Phase

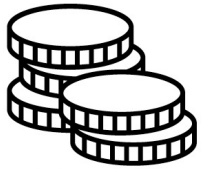
Demand/revenue risk is the risk that the home does not have a tenant. For any periods of vacancy, the owner must still pay the mortgage.



Operating expenses (opex) are regularly recurring costs related to operating the asset, such as insurance and utilities.



Maintenance capex is usually significant lump-sum payments.
E.g., replacing the furnace or the roof.



Reserve accounts are emergency funds that are set aside to help with large payments or if rental revenue is disrupted due to vacancy.

SECTION 4

# Debt



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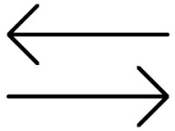
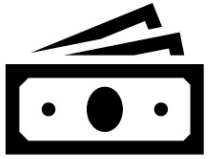
# Key Assumptions and concepts to understand about Debt-Related Items

The initial $350,000 construction loan enables the construction to be completed. Construction loans have high interest rates due to higher risks/uncertainty during construction compared to built assets.



The construction loan is refinanced with a $420,000 mortgage at a lower interest rate, since project risks are lower for a built asset. This also represents a recapitalization and equity take-out event.



Debt service during the operation phase includes both interest payments and principal repayments. All debt obligations will be fully repaid by the end of the project. Any residual funds following opex, maintenance and debt obligations are owner's equity distributions.

SECTION 5

# Cashflow Waterfall



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# Key Assumptions and concepts to understand about Cashflow Waterfall

1. Rental income is the first item at the top of the CF waterfall.

2. All operating expenses (opex) will be covered by the rental income.

3. Major maintenance obligations are paid next.
   - The remaining amount is known as Cash Flow Available for Debt Service (CFADS).

4. Debt service, including both interest and principal.

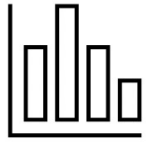
5. Reserve account funding (or release)

6. Any remaining amount is owner's equity distribution (free cashflow)

# SECTION 6

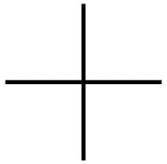
# IRR

# Internal Rate of Return – Project vs Equity



Overall, this rental house project achieved a project IRR of 5.09%. Project IRR is the weighted blended return of the debt and equity

With the boost from leverage, an equity IRR of 7.11% is realized. This reflects the return over the project life to the equity investor



The Equity IRR in this example does not include the residual value of the home and the land after 25 years.

For long-lived assets, this can be a very valuable contribution to the owner but is generally not considered in economic feasibility analysis.

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