Capital Investment Appraisal

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Version Control

Date	Owner	Version	Reason for Change
Dec 2022	Stuart Green	1	New procedure to formalise investment appraisal considerations.

Summary of Changes

Section	Change

Capital Investment Appraisal

Contents

1.0 Introduction

The purpose of this procedure is to set out guidance for the key assumptions to be used when appraising new capital projects that require specific Business Case approval. This is capital investment that is outside of the routine component capital replacement programme across Ark's existing housing stock, or on-going investment in Ark's computer equipment infrastructure.

Capital investment is expenditure that is made in anticipation of long-term organisational benefits, aligned to strategic objectives. It is a major activity within Ark, generally involving significant sums, and carries an element of risk.

This procedure does not aim to be prescriptive, but instead sets out key points of consideration to ensure projects are appraised in an appropriate manner, aligned to Ark's long-term financial planning assumptions. The intention is to enable financial risk associated with capital investment to be understood and managed appropriately.

2.0 Financial Considerations

2.1 Investment Appraisal

Investment appraisal is the analysis done to consider the profitability of an investment over the life of an asset, alongside considerations of affordability and strategic fit. It forms a key input to the investment decision / business case, which will be made by the relevant authorising body, in line with Ark's Standing Orders [G06] and Scheme of Financial Delegation [F02].

The relevant authorising body is the Board of Management, with authority to consider / decide specific matters delegated to the Finance sub-committee, and the Executive Team. The extent of appraisal should be in proportion to the size of the proposed project.

Investment decisions balance a number of elements, including:

- **Affordability:** Can the benefits be delivered within the available funds to Ark when viewed as part of the wider portfolio of operational activities and strategic objectives?
- **Return on investment ("ROI"):** Does the investment deliver a suitable return, given the forecasted capital and operational costs and benefits over the economic life of the product. Is this the best way to get a return on the investment of funds, while also taking into consideration Ark's charitable objectives?
- **Portfolio effect:** Does the investment fit alongside the wider set of investments in operational and strategic objectives?

These considerations should be included as part of any Business Case presented for approval.

2.2 Project Funding

Project funding is the means by which the money required to undertake a project or programme of works is secured and then made available as required.

As part of all capital investment appraisals, reference to the source of funds should be included. In the majority of cases, project funding will be included within Ark's Five-Year Financial Plan ("FYFP") and annual budget.

Where funding has not been included within Ark's FYFP or annual budget, or where funding requirements are materially different to that included, the appraisal must consider the revised impact on debt, cash flow, Ark's ability to continue to meet it loan covenants, and any other financial measures that are considered relevant. This is to ensure that the appropriate authorising body is aware of, and can assess, the financial implications of the business investment decision being considered for approval.

2.3 Social Value

Social value is a way to quantify how different interventions affect people's lives – the overall impact on people's wellbeing, or their quality of life. It is a way of measuring the positive benefits our work has on both individuals and communities.

By measuring the social value Ark creates, we can evidence the impact Ark has on the people and communities we work with. It also supports us to make informed decisions about on-going service improvement.

As a Registered Social Landlord and Charity, Ark's mission is to:

'Create the best possible customer outcomes through our highly skilled people, the provision of high quality affordable homes and excellent care'.

The authorising body, in considering capital investment projects, should factor social value created as part of the wider project business case.

3.0 Appraisal Technique's

There are a number of analytical techniques suitable for assessing an investment proposal in financial terms. They are based on estimates of the future cash flows associated with a project, and include:

- **Payback method:** The number of years it is expected to take to recover the original investment from the net cash flows;
- **Accounting rate of return:** The accounting rate of return of a project is compared to the organisation's existing (or target) return on capital employed;

- **Net present value ("NPV"):** A discount rate is used to convert future cash sums into their present day cash equivalents;
- **Discounted payback:** Cash flows are discounted before accumulating them to obtain the payback period; and
- **Internal rate of return:** The appropriate discount rate is determined by calculating the internal rate of return ("IRR") of the project. The IRR is that discount rate which produces a net present value of zero.

Different methodologies can give conflicting results and so care should be taken when interpreting these. It is recommended that a range of techniques are used, giving additional assurance to the figures included within any investment appraisal / business case.

Sensitivity analysis on key assumptions used in any appraisal is critical. This allows the authorising body to consider financial risk inherent in any investment project, assessing impact against likelihood.

4.0 Discount Rate

In discounted cash flow analysis, the discount rate is a key assumption. The higher the discount rate, the lower the present value of future project cash flows (therefore reducing the likelihood of the appraisal showing a positive result). However, setting the 'right' discount rate is not always straightforward.

This procedure recommends two key benchmarks when considering the appropriate discount rate to use.

4.1 Return on Equity ("ROE")

This is a measure of financial performance, gauging how efficiently an organisations net assets are in generating surpluses. It is calculated by dividing net income (surplus) in any year against average reserves.

It allows an organisation to identify a discount rate to be used in future investment appraisals, assuming that any new investment (within the same area of operation) would seek to generate at least the current level of return that an organisations existing assets are generating.

Results may be skewed by volatile results in the Income & Expenditure account, accounting adjustments such as pension re-valuations, or surpluses generated / losses incurred from non-asset related activity (such as Care & Support). These should be excluded to calculate an appropriate rate.

4.2 Cost of Debt

This is the effective interest rate that Ark pays on its external borrowings. This may be the interest rate on new borrowings specific to an investment project, or the weighted average cost of Ark's total debt.

The interest rate on Ark's debt may also change over time. This may be a risk if the project is appraised over a different timescale. It can be mitigated against by adding a 'risk premium' to the discount rate used in the appraisal, or by seeking to achieve a NPV result in excess of £nil. This procedure recommends the latter, as it allows for a more informed assessment of risk, based on the NPV result achieved.

5.0 Areas of Capital Investment

Capital investment expenditure at Ark is incurred across four key areas. These are summarised below, noting whether a capital investment appraisal would be expected in the usual course of business.

5.1 Core Programme

This is the routine component replacement programme across Ark's existing housing stock. Investment requirements are informed by a range of factors, including:

- Lifecycle analysis;
- Understanding the current state / quality of components;
- Customer requirements;
- Ark's aspirations to be a provider of high-quality housing;
- Tenant satisfaction results; and
- Funds available.

Investment expenditure levels included in Ark's Five-Year Financial Plan ("FYFP") and annual budget should reflect the requirements of the Asset Management Strategy ("AMS").

Specific investment appraisals would not be expected under this budget line.

Material changes to Ark's long-term expenditure investment requirements would be reflected in an updated AMS, which may be influenced by changes in Ark's regulatory environment (such as increased energy efficiency targets), inflationary pressures within the building sector, or changing assumptions around the expected components or quality of Ark's housing stock.

5.2 New Build Development

New build development refers to the construction, or purchase, of new housing stock. This includes properties for social, mid, or full-market rent.

Development investment funding and expenditure included within the FYFP should be based on appropriate cost information, grant allocation, and private finance requirements. This will be split between site and non-site-specific units, depending on information available at the time of setting the FYFP. This will inform Ark's high-level capacity and financial parameters (including ability to borrow) for future development.

Site-specific development projects (once identified) are subject to financial and risk management appraisal at pre-acquisition and pre-tender stage, both of which are subject to Finance sub-committee review, and Board of Management approval.

Approved development projects will be separately identified within the financial plan, and should be aligned to the approved financial appraisal.

Appendix 1 sets out the most common assumptions to be included within a new build capital investment appraisal. These align with assumptions used throughout the Social Housing sector in Scotland, however, as noted at 3.0 above, additional assumptions or appraisal techniques are recommended to be used to provide additional internal assurance.

The key financial principle is to ensure that operational cash flows from new developments are sufficient to service debt and investment responsibilities over the life of the asset, without posing a financial risk to the wider organisation.

5.3 Strategic Asset Management ("SAM")

The financial plan includes significant long-term funding to support the strategic review of Ark's assets. The purpose of this is to review, at a strategic level, the overall business performance of our existing assets and associated services, ensuring they continue to align with business needs and objectives.

Anticipated expenditure, and income (such as sale proceeds), should be reflected in the FYFP / annual budget, based on information available at the time of setting the FYFP / annual budget.

Specific SAM projects (once identified) are subject to financial and risk management appraisal at feasibility and pre-tender stage, both of which are subject to Finance sub-committee review, and Board of Management approval.

Due to the transformational nature of these projects, the financial appraisal, although important, should be viewed within the context of Ark's wider organisational objectives and purpose.

Appendix 2 sets out the most common assumptions to be included within a SAM capital investment appraisal. Appropriate assumptions within Appendix 1 may also be used where relevant.

5.4 Other Fixed Assets (“OFA”)

Other Fixed Assets are all other capital assets owned by Ark that are not housing properties, such as computer hardware and software, office buildings, and furniture and equipment.

Investment can be routine, such as the on-going purchase of ICT equipment to maintain the running of the organisation, or one-off in nature, such as the purchase or sale of an office building.

Capital investment appraisals should be used where expenditure is deemed ‘outside the course of business as usual’. This may involve, but not be limited to the following scenarios:

- Office purchase or disposal (including leases);
- Significant ICT investment or project;
- High value, or large-scale, equipment purchase / replacement / enhancement.

Professional judgement should be used as to whether an investment appraisal is required for capital expenditure under this heading.

6.0 Implementation and Review

6.1 Implementation

The procedure’s author, or other appropriate employee as delegated by Ark’s Director of Finance, will ensure that this procedure is followed by all Board Members and members of staff involved in any capital investment appraisal.

6.2 Review

This procedure will be reviewed at least once every 3 years, per Ark’s policy and procedure review cycle. The procedure’s author, or other appropriate employee as delegated by Ark’s Director of Finance, is responsible for updating and submitting to Ark’s Policy & Procedure Review Group.

Appendix 1: Common Investment Appraisal Assumptions – New Build

The table below notes the key assumptions to be included within a financial appraisal for new affordable housing within Ark. These assumptions have been developed with ‘standard’ new build developments in mind. Where circumstances differ on specific developments, professional judgement should be used to consider whether additional assumptions are required to be included within the investment appraisal.

No.	Appraisal Assumption	Description
1	Appraisal Technique	Net present value.
2	Discount Rate (%)	To be set in line with Ark’s cost of capital, or in line with the ‘all-in’ interest rate on new funding sources (interest rate + cost of arranging new funding).
3	Discount (Payback) Period (Years)	Positive cash position by Year 30.
4	Net Present Value (NPV) (£)	NPV should exceed £0 – Reasonable risk premium relative to project should be considered and reflected in a higher NPV target (e.g. NPV to equal 10% of net development cost). Developments with a negative NPV or insufficiently positive NPV to be considered for approval only if deemed as strategically important.
5	Residual Value (RV) (£)	No RV included – unless intention is to sell.
6	Development Cost (£)	Directly attributable cost of initial development.
7	Housing Association Grant (£)	Directly attributable grant funding received to support initial development.
8	Rent Amount (£)	In line with New Build rent policy.
9	Rent & Cost Inflation (%)	In line with long-term financial plan.
10	Voids & Bad Debt (%)#	In line with long-term financial plan.
11	Service Charges (£)#	Not included in appraisal – set on a development by development basis, with income assumed to cover 100% of expenditure.
12	Management Fee (£)#	£200 per unit per annum – to cover buildings insurance, Housing Officer provision, and other routine housing management running / departmental costs.
13	Reactive Repairs (£)#	In line with average per unit cost included in long-term financial plan, unless the proposed property has a significantly different structural or component makeup.
14	Cyclical Maintenance (£)#	In line with average per unit cost included in long-term financial plan, unless the proposed property has a significantly different structural or component makeup.
15	Major Capital Repairs / Component Replacement (£)#	In line with average per unit cost included in long-term financial plan, unless the proposed property has a significantly different makeup.

Different assumptions may be used depending on housing tenure (General Needs, Supported Housing).

Appendix 2: Common Investment Appraisal Assumptions – SAM / OFA

The table below notes the key assumptions to be included within a financial appraisal for all SAM or OFA projects within Ark. Where circumstances differ, professional judgement should be used to consider whether additional assumptions are required to be included within the investment appraisal.

No.	Appraisal Assumption	Other Capital Investment
1	Discount Rate (%)	To be set in line with Ark's cost of capital, or in line with the 'all-in' interest rate on new funding sources (interest rate + cost of arranging new funding).
2	Discount (Payback) Period (Years)	Relative to investment and other opportunities.
3	Net Present Value (NPV) (£)	NPV should exceed £0 – Reasonable risk premium relative to project should be considered and reflected in a higher NPV target (e.g. NPV to equal 10% of net development cost). Developments with a negative NPV or insufficiently positive NPV to be considered for approval only if deemed as strategically important.
4	Residual Value (RV) (£)	No RV included – unless intention is to sell.
5	Other Income & Cost Assumptions (£ or %)	Project dependant.