Midland Oval Redevelopment Precinct Business Plan

Submission for and on behalf of the following City of Swan Ratepayers and Residents Associations

- Bullsbrook Residents and Ratepayers Association Inc.
- Gidgegannup Progress Association Inc.
- The Guildford Association Inc.
- Stratton Community Association Inc.
- Swan Valley Ratepayers and Residents Association Inc.
- Upper Swan District Ratepayers and Residents Association Inc.
- Woodbridge Ratepayers Association Inc.

22 August 2018

Overview

Pursuant to the invitation by the City Of Swan ("CoS") for interested parties to provide submissions on the Midland Oval Redevelopment Precinct Plan and the underlying Midland Oval Precinct Business Plan ("Business Plan"), the Swan Valley Ratepayers and Residents Association ("SVRRA") has prepared and submit this review on behalf of and with the endorsement of the following CoS ratepayers and residents associations.

- Bullsbrook Residents and Ratepayers Association Inc.
- Gidgegannup Progress Association Inc.
- The Guildford Association Inc.
- Stratton Community Association Inc.
- Swan Valley Ratepayers and Residents Association Inc.
- Upper Swan District Ratepayers and Residents Association Inc.
- Woodbridge Ratepayers Association Inc.

This submission makes no comments and provides no opinion on the social merit of the Midland Oval Redevelopment Precinct Plan. Rather, it is focused solely on the robustness of the financial modelling that underpins the Business Plan and by extension the financial implications that the Midland Oval Redevelopment may have on the ratepayers and residents of the CoS.

Summary

1. The Midland Oval Redevelopment Precinct Plan as presented represents a significant financial risk to CoS ratepayers and residents.
2. The underlying financial model appears to be overly optimistic with its inputs and assumptions and does not adequately consider the usual operating risks associated with a development of this scope or type.
3. The proposed development of the Midland Oval precinct will require rates to be increased over and above the status quo in order to fund part or all of the CoS's development costs.
4. The CoS will also be required to increase its level of borrowings.
5. The level of services to ratepayers and residents will likely be constrained during the proposed development.
6. The financial outcome of the proposed development is not commiserate with the high level of development risk.
7. The scale of the proposed development will have significant negative financial implications for existing retail and office leasing businesses in the Midland area.

Review Methodology

The SVRRA has reviewed the Business Plan on the basis that it is a definitive document supported by underlying detailed costings and financial model. The SVRRA believes this is a reasonable assumption based on the established facts that:

- the CoS established a vision for the redevelopment of Midland Oval as far back as August 2011 and
- the Business Plan states that the financial modelling has been undertaken by the Western Australian Treasury Corporation ("WA Treasury") and
- Land acquisition and site works have already commenced implying the Business Plan and financial model are part of an underlying definitive feasibility study ("DFS").

We note that of the four development scenarios provided only scenarios 3 and 4 provide a positive Total Net Cash Flow (Nominal) over the initial 10 years and only Scenario 3 provides a positive Net Present Value ("NPV") over all any time period. (Business Plan Page 19).

As a positive NPV is a pre-requisite for all developments we have assumed that only Scenario 3 is being seriously considered by the CoS.

Convention is that NPV calculations over developments of this size and duration are generally carried out over 10 years as that time period would cover at least two economic cycles and assumptions over Consumer Price Index ("CPI") can generally be better risk managed.

In addition, unless an investor has the balance sheet and cash flow of say a BHP (one that can ride through multiple adverse economic outcomes) it is usual not to ascribe any value to cash flows beyond the 10 year period.

As a consequence and for the purpose of this submission by the SVRRA we have therefore focused on the initial 10 year segment of the Scenario 3 development option as tabled on pages 19 and 20 of the Business Plan.

Key Points

In reviewing the key financial outcomes contained in the Business Plan we were disappointed that this Business Plan – which is meant to underpin a very significant financial and development commitment to the COS, did not contain a greater level of financial detail – in particular a breakup of the cash flows.

For example, as the financial modelling by WA Treasury would have modelled the proposed development on at least three monthly or six monthly increments, it would have been reasonable to expect that at the very least summary annual cash flow data be included in the Business Plan.

The inclusion of annual cash flow data for example would have permitted a more definitive analysis by interested parties of the financial model.

Specifically, annual cash flows would have allowed a better understanding of critical project financial aspects such as the relative skewness of the cash flows over the 10, 15 and 20 year periods.

<u>Cash Generation</u>

By analysing the development expenditure, NPV and nominal free cash generated over the 10, 15 and 20 year segments under Scenario 3 (as tabled on page 20 of the Business Plan) it is clear that the majority of income from lot sales, building asset sales and rates for example is skewed towards the latter years of the years 1-10 segment.

Under Scenario 3, $130.3 million in nominal cash flow is budgeted to be generated in years 1-10 (sum of positive cash flows Scenario 3 column 3 Business Plan Page 20) On the basis of the expected skewness of this cash flow we have assumed that 10% will be generated in years 1-4, 30% in years 5-7 and 60% in years 8-10.

As with developments of this size and type the opposite is true for the capital that needs to be expended to realise these cash flows.

We have therefore assumed that of the estimated capital expenditure over years 1-10 of $88.7 million (sum of negative cash flows Scenario 3 column 3 Business Plan page 20 includes 16.9 million development cost of Multi-deck car park) 60% would be in years 1-4, 30% in years 5-7 and 10% in years 8-10.

The net cash flows through years 1-10 is therefore interpreted to be:

Segment	**Years 1-4**	**Years 5-7**	**Years 8-10**	**Total**
Capital Expenditure ($m)	$53.2	$26.6	$8.9	$88.7
Cash Generated ($m)	$13.0	$39.1	$78.2	$130.3
Net Cash Flow ($m)	**-$40.2**	**$12.5**	**$69.3**	**$41.6**

Table 1: Segmented nominal cash flows, years 1-10 Scenario 3.

Table 1 shows that for the initial 4 years of project life the COS will be required to source an estimated $40.2 million in additional capital in order to support the funding of the proposed development.

The two primary controllable sources of funds for the COS are rates and borrowings.

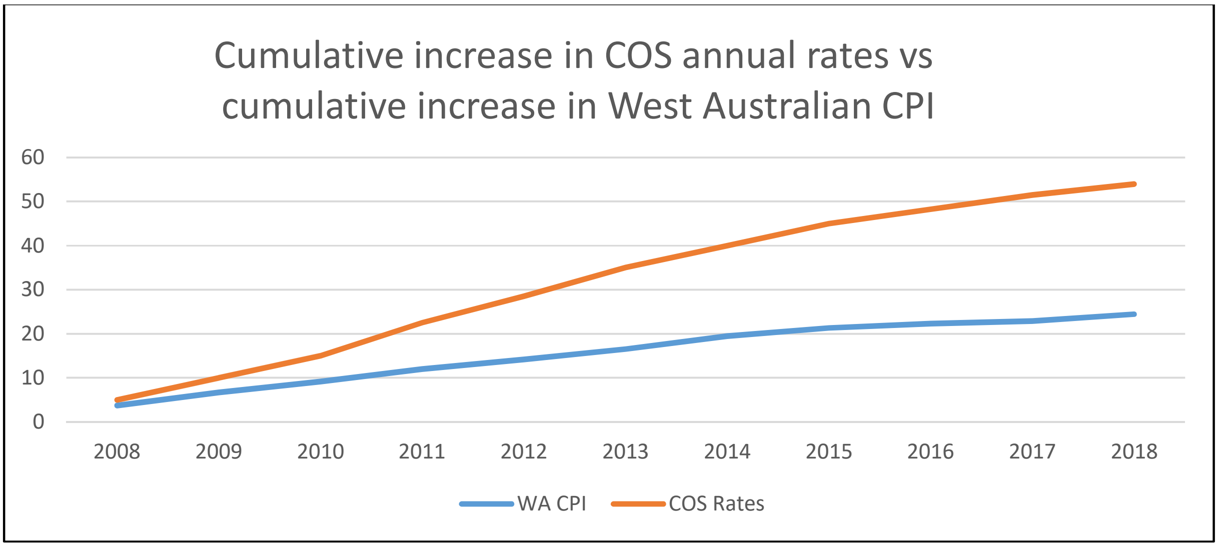

Chart 1: Cumulative percentage increase in COS rates and West Australian CPI 2008-2108 inclusive

As can be seen from Chart 1 the ratepayers of the CoS have already been penalised heavily over the past decade with cumulative rate increases of 54.0% compared with the cumulative increase in the West Australian CPI of only 24.4%.

This imposition on ratepayers to fund the CoS through rate increases over double the rate of West Australian inflation is unfortunately a trend set to continue based on the financial model presented.

If the cash shortfall for example is to be wholly CoS funded then the CoS will need to raise an additional 8-12% in rates revenue over and above the annual rate increases that ratepayers currently experience (based on the budgeted $123.5 million in rates generated for FY 2018). This projected increase will be required over at least each of the initial four years of the proposed development.

If the CoS choose to fund part of the cash shortfall through additional borrowings – something that has yet to be factored into the financial modelling as evidenced by the commentary in the Business Plan Page 16 paragraph 3, then a funding cost will need to be applied to the financial model.

It should be noted that if borrowings are used to fund the proposed development – either solely or in a combination with increased rates, this funding cost could be significant with a 50:50 funding split for example incurring likely interest charges of +$1.5 million per annum.

<u>This funding charge will impact the nominal cash flows underpinning the Business Plan and cause the projected NPV of $869,000 under Scenario 3 to become negative.</u>

Whether 100% of CoS funds or a combination of equity and debt, the requirement to fund an estimated $40.2 million in operating cash shortfall over years 1-4 has significant implications for all CoS ratepayers. These implications include the risk of increased rates together with a significant cutback in CoS services to ratepayers and residents in order to maintain the annual CoS budget in surplus.

<u>CPI</u>

The Business Plan financial model has utilised WA Treasury's estimates of the long term West Australian Consumer Price Index (CPI) of 2.5% to convert a midpoint discount rate of 7.0% to a nominal rate of 9.5% (Business Plan page 19).

The reasonableness of these CPI assumptions will only be known with time.

Nevertheless it is important to note that we are already beginning to see inflation increase on a global scale and if this rising inflation is a pre-cursor to the Australian economic cycle reverting to its pre GFC characteristics then the 2.5% CPI used for the financial modelling will prove to be far too low over the 10 year time frame of the financial modelling.

This has serious implications for input costs such as labour and materials as well as financing costs.

In more specific terms various building and construction costs indices for example are already showing inflationary pressure with the rate of increase in the price of construction inputs such as materials and labour now trending above the WA Treasury's CPI forecast of 1.5% for FY 2019 and 2.0% for FY 2020 (Page 19 Business Plan) – see Table 2.

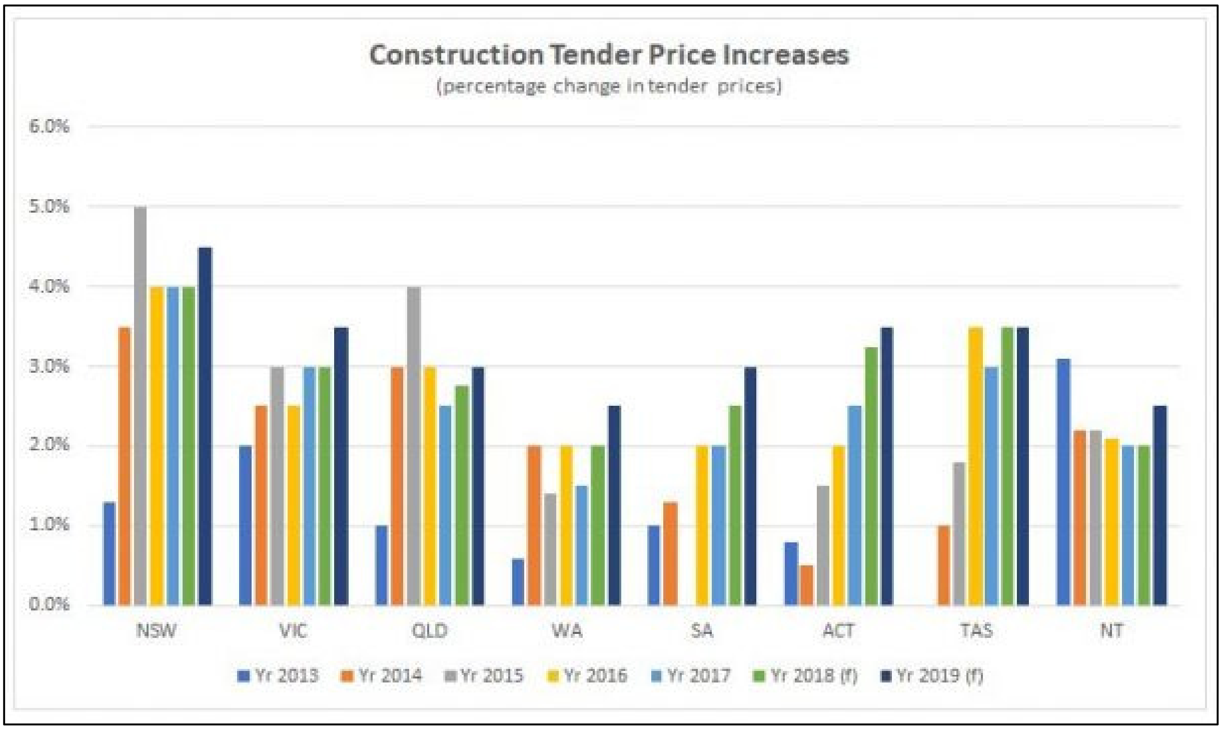

Table 2: Construction Tender Price Increases (actual and projected) (WT Markets: Construction Price Conditions 2018)

An increase in inflation over and above the 2.5% figure used for the financial model will have serious implications for the budgeted development costs as well as cost of financing and hence negative implications for the calculated NPV. The long term average CPI rate of 2.5% is too low.

<u>Discount Rate</u>

The discount rate is a measure of the risk of the project and underlying assumptions pertaining to the proposed development.

The discount rate of 7.0% (real rate) used in the financial model to generate the Nominal Discount Rate (Business Plan – Page 19) implies the proposed development of the Midland Oval precinct and all of the underlying financial assumptions as being of low risk.

The Business Plan also notes that the proposed development can be managed to reflect economic conditions (Business Plan – Page 16).

As a general statement a proposed development with multiple aspects to it such as the Midland Oval development (purchase and sale of land, residential, retail and office construction) would be considered as having a risk profile much higher than low.

In addition and with respect to the CoS, there are unfortunately many historic and recent examples where both public and private entities developments have been caught out by an unexpected or mis-managed change in economic conditions.

The best way to manage these potential but likely occurrences is to build a financial model that balances risk with reward and does not assume a "Goldilocks" economic environment.

Building on that comment it is an unfortunate fact that financial modelling rarely gets it right

Whether the private or public sector, financial modelling often proves to be wildly optimistic by overstating revenue and revenue timing and understating costs.

As an example and in just considering costs, the Grattan Institute published a report in October 2016 which analysed transport infrastructure projects built since 2001. On average these projects cost 25% more to build than budgeted.

We note that the Business Plan financial model includes a contingency of 10% on costs but suggest – in light of the above comments and the time frame of the proposed development, that a contingency of at least 15% would have been more appropriate and conservative.

With a NPV of only $869,000 under Scenario 3 – years 1-10, the financial model is telling the CoS and ratepayers that if the cost inputs and revenue projections vary even by a small degree then there is a very fine line between economic success and failure.

A discount rate of at least 12.5% and a contingency of at least 15% would appear more appropriate in the financial modelling for this proposed development.

<u>Development Risks</u>

The Business Plan is based on the proposed development delivering an additional 23,000 square metres of retail space and 75,000 square metres of office space to Midland.

They are big numbers.

To put them in context the current expansion of the Midland Gate shopping centre will take it to 69,000 square metres with 215 retailers on completion. This is ostensibly to cater for the expected increase in population of 24% in the Swan growth corridor by 2025 (Vicinity Centres press release May 2017).

It could be argued that the proposed development of Midland Oval will cater for a different type of retailer with a focus on restaurants and specialty stores. The proposed 23,000 square metres is nevertheless a lot of restaurants and specialty stores in what will already be a well catered retail environment for Midland and its proximal catchment.

It is obvious that a large proportion of the proposed retail space will need to seek tenants who would compete directly with Midland Gate and other existing and planned retail entities and would place leasing pressure on those entities.

Notwithstanding that and with increasingly deregulated retailing hours the Midland Gate development alone will represent formidable competition to the successful sale or lease of the proposed new retail space of the Midland Oval development.

The 75,000 square metres of new office space is something else altogether. That is equivalent for example to three 31 level Allendale squares or 1.2 times a new 42 level QV1 building and those offices are in Perth's CBD which would make successful leasing less challenging than a regional location such as Midland.

In an environment where demand for office space is expected to decrease rather than increase relative to population growth, that part of the proposed development will also present sale and leasing challenges.

In the context of key aspects of the Business Plan it would be argued that the scope of the development, in particular regard to the volume of new retail and office space is ambitious and increases the financial risk profile.

Interest Rates and the Economic Cycle

The global economy is experiencing a tightening in credit markets which will translate to increased interest rates in Australia over the medium term.

Already for example the Macquarie Bank and AMP have increased the rates they charge for housing loans.

An increasing rate cycle generally has negative implications for the rate of economic growth which will therefore have an economic impact within the initial 10 years on the proposed development.

The success of the proposed development is heavily reliant on a strong economy and one that is in a continuous growth phase. In a tightening rate cycle that reliance exposes the CoS and Swan Valley ratepayers to a serious financial risk.

Conclusion

The Midland Oval Redevelopment Precinct Business Plan has an underlying financial model that has been developed using a range of aggressive assumptions.

The proposed development consequently presents a serious financial risk to the CoS and its ratepayers and residents.

It is also questionable if the Business Plan has been developed based on a feasibility study or instead has used a scoping study as its basis for moving forward.

For any development of the size of the Midland Oval Redevelopment, detailed financial modelling is a pre-requisite so the financial risks can be properly understood and managed.

It is recommended that a detailed financial analysis with conservative economic assumptions be prepared before further development of the Midland Oval Precinct is undertaken.