Report for the Advisory Board, Nancledra Preschool. Prepared by Roger Clough, Clough Accounting. 29th November 2023

Terms of Reference

Nancledra Preschool currently rent the premises for £1,800 per calendar month. The proposal is to take out a mortgage of £198,750 in order to purchase the property for £265,000. The remaining £66,250 will be funded by a Cornwall Council grant of £50,000 and money on deposit in the preschool bank accounts. For the calculations £2,500 in legal fees have been estimated and added, as well as HSBC arrangement fees of £2,484. The advisory board have requested that this be looked at to help aid the decision making in whether to purchase the building.

Executive Summary

Over the ten-year fixed period of the mortgage, the effect on cash and profit is favourable if the purchase goes ahead. In summary ten years after purchase:

- Cash position would be £28,626 better than if renting continues.
- Profit position would be £71,797 better than if renting continues - on a cumulative basis over the yen year period rather than per year.

In the short term the preschool will be worse off in cash terms in particular, so the board should satisfy itself that the preschool has sufficient reserves to be worse off in cash terms by:

- £21,234 before and immediately up to the purchase date
- £16,248 one year after the purchase
- £11,262 two years after the purchase
- £6,276 three years after the purchase

Cash and profit positions

- Cashflow position will be negatively affected for 4 years and 4 months. After this point cashflow position will be positively affected.
- In terms of profitability, this is different to the cash position because of the repayment element of the mortgage. This will be negatively affected for 2 years and 7 months.

Also bear in mind

- Rent can go up, so there is some risk in continuing with the current arrangement.
- Mortgage rates can go up or down. You are wise to consider a ten year fix, however there is a fixed rate break fee of up to £19,875. This decreases during the term of the mortgage, but could prevent you from moving to a cheaper rate if base rates fall, which seems at least possible over ten years.

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Purchase and Mortgage Information

HSBC are proposing a 10-year fixed rate at 6.84% on a 25-year term. After the 10-year fix this would revert to the Bank of England base rate plus 2.25% (currently the Bank of England base rate is 5.25%, so this would be 7.5%)

Repayments during the 10-year fix period would be £1,384.50 per month, which compares favourably with the rent which is presently £1,800. However, you would have invested a deposit of £66,250 + £2,484 arrangement fees + £2,500 legal fees - £50,000 grant, so £21,234 in order to achieve this saving. Furthermore, just comparing the monthly mortgage payment with the rent over-simplifies the situation as part of the mortgage payment is going towards repaying the capital while the rest is covering the interest.

From this point on, all figures are annual rather than monthly, in order to make comparisons clearer. The table below shows the interest and capital repayment breakdown of the proposed mortgage over the ten-year fixed term:

Year	Interest paid	Capital repaid	Total repayments	Mortgage bal @ year end
1	£13,498	£3,116	£16,614	£195,634
2	£13,278	£3,336	£16,614	£192,298
3	£13,043	£3,571	£16,614	£188,727
4	£12,791	£3,824	£16,614	£184,903
5	£12,521	£4,093	£16,614	£180,810
6	£12,232	£4,382	£16,614	£176,427
7	£11,922	£4,692	£16,614	£171,736
8	£11,591	£5,023	£16,614	£166,713
9	£11,237	£5,377	£16,614	£161,335
10	£10,857	£5,757	£16,614	£155,578

Figures from the table above are used in the following calculations too.

Initial cost of purchasing.

£66,250 deposit plus £2,484 arrangement fees and £2500 legal fees comes to £71,234, less the £50,000 grant from Cornwall Council means that the initial net outlay to purchase the building is in the region of £21,234. This compares to nil for continuing to rent.

Ongoing cost of purchasing

This needs to be looked at in two ways. Effect on cash and effect on profit (or surplus) because some of the mortgage payments are going towards paying off the mortgage rather than just servicing the debt.

Ongoing cost of purchasing – effect on cash

On a day-to-day basis, effect on cash is important, so the board should satisfy itself that it has sufficient reserves to get through to the point when the cash position recovers. The table below shows that this is 4 years and 4 months. From the point of purchase to 4 years and 4 months later, the preschool will have less cash available than if it decides to continue to rent. From 4 years and 4 months, the preschool will have more cash available than if it decides to continue to rent, and by the end of year 10 this would amount to £28,626 which is a considerable sum over 10 years:

End of year	Cash position if rent continues	Initial costs of purchasing	Money paid out on mortgage	Total cash position from purchasing	Difference (negative means purchasing uses more cash)	Cumuative difference
1	-£21,600	-£21,234	-£16,614	-£37,848	-£16,248	-£16,248
2	-£21,600		-£16,614	-£16,614	£4,986	-£11,262
3	-£21,600		-£16,614	-£16,614	£4,986	-£6,276
4	-£21,600		-£16,614	-£16,614	£4,986	-£1,290
5	-£21,600		-£16,614	-£16,614	£4,986	£3,696
6	-£21,600		-£16,614	-£16,614	£4,986	£8,682
7	-£21,600		-£16,614	-£16,614	£4,986	£13,668
8	-£21,600		-£16,614	-£16,614	£4,986	£18,654
9	-£21,600		-£16,614	-£16,614	£4,986	£23,640
10	-£21,600		-£16,614	-£16,614	£4,986	£28,626

Ongoing cost of purchasing – effect on profit (or surplus)

Whilst the effect on cash is important, what matters in terms of profit is different, because some of the mortgage payments are paying down the debt. So, in year 1 for example, from the mortgage payments of £16,614, a sum of £3,116 goes towards repaying the debt, and the remaining £13,498 is interest on the debt. As the debt is paid down over the years the interest payments decrease and the capital repayments increase, within the £16,614 mortgage payments, so in year 10 £5,757 goes towards repaying the debt, and the remaining £10,857 is interest. From the point of purchase to 2 years and 7 months later, the preschool will have made less profit (or surplus) than if it decides to continue to rent. From 2 years and 7 months, the preschool will be more profitable than if it decides to continue to rent, but it may not feel like this as some of this profit is effectively invested in the building.

After 10 years the preschool will have made £71,797 more profit (or surplus) by purchasing than from remaining in a rental position. Again, this is a considerable sum over 10 years:

End of year	Profit position if rent continues	Profit position from purchasing (yr1 only)	Money paid out on mortgage INTEREST	Total profit position from purchasing	Difference (negative means purchasing creates a loss)	Cumuative difference
1	-21600	-21234	-£13,498	-£34,732	-£13,132	-£13,132
2	-21600		-£13,278	-£13,278	£8,322	-£4,810
3	-21600		-£13,043	-£13,043	£8,557	£3,747
4	-21600		-£12,791	-£12,791	£8,809	£12,557
5	-21600		-£12,521	-£12,521	£9,079	£21,636
6	-21600		-£12,232	-£12,232	£9,368	£31,005
7	-21600		-£11,922	-£11,922	£9,678	£40,682
8	-21600		-£11,591	-£11,591	£10,009	£50,691
9	-21600		-£11,237	-£11,237	£10,363	£61,054
10	-21600		-£10,857	-£10,857	£10,743	£71,797

Key points.

If you decide to purchase the building with the proposed mortgage, then:

1. You will be worse off in cash terms for 4 years and 4 months than you would be if you decide to continue renting.
2. Although you will be worse off in terms of cash for 4 years and 4 months, on a monthly or annual basis you will begin to become better off straight after the purchase. But it will take 4 years and 4 months to make sufficient savings to get back to the cash position you would have been in if you continued renting.
3. The biggest difference in cash position will be immediately after the purchase, the preschool is effectively investing £21,234 upfront and recouping this over the 4 years and 4 months.
4. Because of the capital repayment element of the mortgage payments, in profitability terms you will be better off in 2 years and 7 months if you decide to purchase the building.
5. You gain some certainty by fixing for 10 years, undoubtedly. If interest rates fall however, you could be locked into what could later seem an expensive product because of the redemption penalties. These are £19,875 at the start of the ten year term and drop throughout the 10 year term.
6. In terms of profitability, the preschool will be in a better position much more quickly, this will recover in 2 years and 7 months if purchasing.
7. Profitability will improve by between £8,000 and £10,000 per year from purchasing the building.
8. There is risk to continuing to rent too, as rent reviews could increase the rent figure payable and change all of these calculations.

Report dated 29th November 2023. Not intended as advice, rather as an analysis to aid decision making.

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