

# FINANCIAL METRICS GUIDE

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ARUP



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# UNDERSTANDING FINANCIAL METRICS

# What does success look like?

**The purpose of this guidance note is to support the Towns to think through how different types of measures can be used to assess success for their intended outputs and outcomes.**

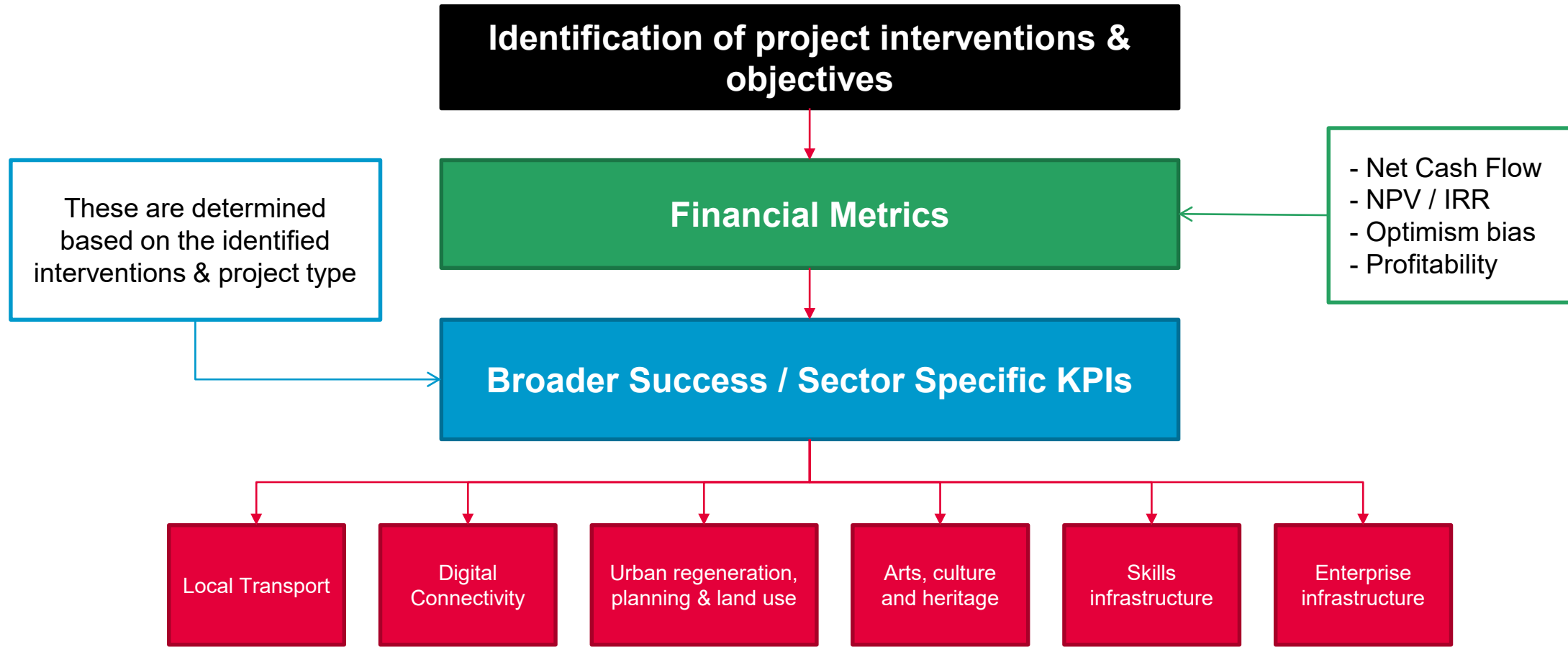
It enables Towns to understand which measures are best suited to their needs dependent upon the interventions proposed and the context of their place.

This will allow them to not only prepare a TIP which considers the preferred option(s) but allows them to consider a suite of scenarios as part of their internal thinking.

## **AIMS OF THIS DOCUMENT**

- This guidance note explores a range of key general financial metrics which can be applied to all project types.
- It also lists examples that are specific to the sector which the Town wishes to operate in.
- Within each slide, we provide for each key financial metric:
  - A brief description;
  - What good looks like; and
  - Opportunities for Towns to present their view on specific metrics.

# Overview of measuring success



# FINANCIAL METRICS

# Overview of financial metrics and business case development

**The development of a strong business case will enable the delivery of key outputs and benefits for the Town.**

It allows for the identification of key strategic objectives, required tools to deliver the project, effective risk management and the assignment of roles and responsibilities.

A business case will outline key financial targets and performance indicators for the project to succeed and the initial capital requirements to fund the project.

We recommend all Towns develop their business cases using the HM Treasury Green Book 5-case model as guidance.

## IMPORTANCE OF FINANCIAL METRICS

- Financial metrics can be used to analyse, interpret and utilise financial information to assess operational efficiency, liquidity, stability and profitability of a project.
- They can be used in preparing forecasts and budgets, to understand whether a project is affordable and viable to deliver. Interpreting key financial metrics can be key in the decision making process to the delivery of a project.
- Towns can set quantitative targets to also measure outputs and outcomes of their proposed interventions. These can be tailored to the Town's needs.

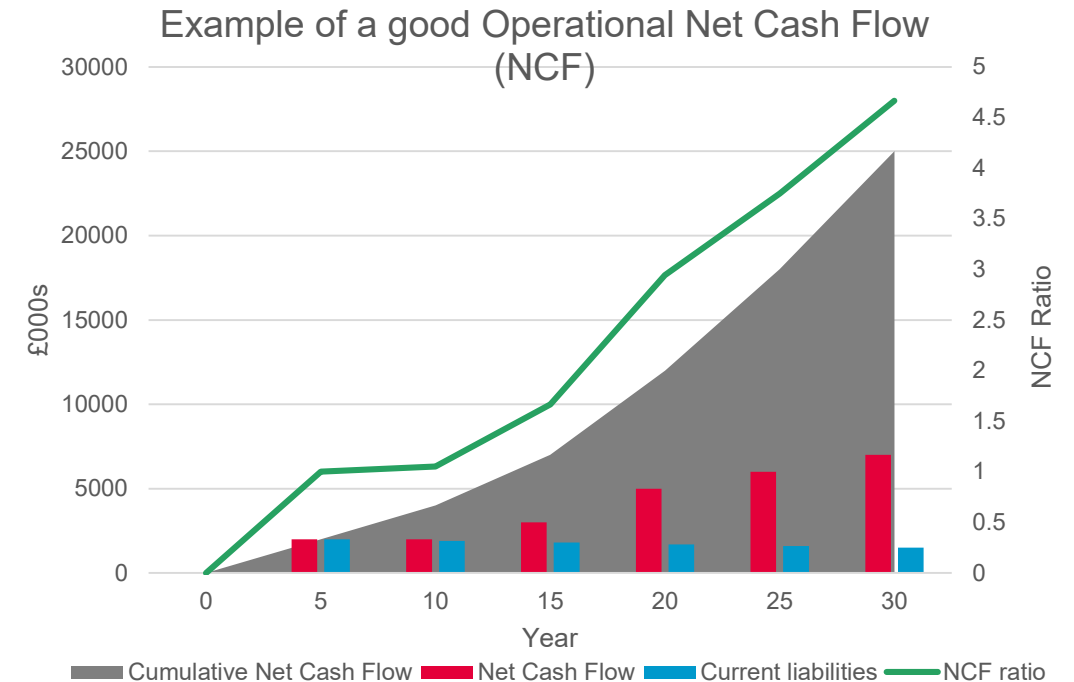
# Operational Net Cash Flow

The total operational cash inflows less total operational cash outflows during the project life.

## WHAT GOOD LOOKS LIKE

- Annual total cash inflows exceed cash outflows on an annual basis after all development costs are incurred.
- Alternatively an **operating net cash ratio** can be considered, which calculates operational net cash flow over current liabilities\*. If the ratio is greater than 1, this can be considered a reasonable net cash flow.
- We note that there may be negative operational net cash flows due to high capital lifecycle costs relating to capital maintenance. The Town may consider its own reserves or third-party funding sources to cover these.

\* financial obligations to be met within one year, such as interest amounts and/or funding repayments to be serviced.



## Comments (to be completed by the Town)



# Discount Rate / Risk Factor

**The discount rate reflects the overall cost of capital and can be presented inclusive/exclusive of inflation.**

Under HM Treasury Green Book terms, the discount rate for long term major capital projects in real terms is usually set at 3.5% per annum for the first 30 years, and then 3.0% per annum thereafter.

## WHAT GOOD LOOKS LIKE

- Discount rates typically range between 1-15% depending on the type of the project and the associated risk attached to a project, and so the Green Book rate represents a relatively low rate as a discount rate.
- This means that where there is a riskier project, this usually leads to a higher cost of capital and thus a higher discount rate is used in evaluating forecasts.

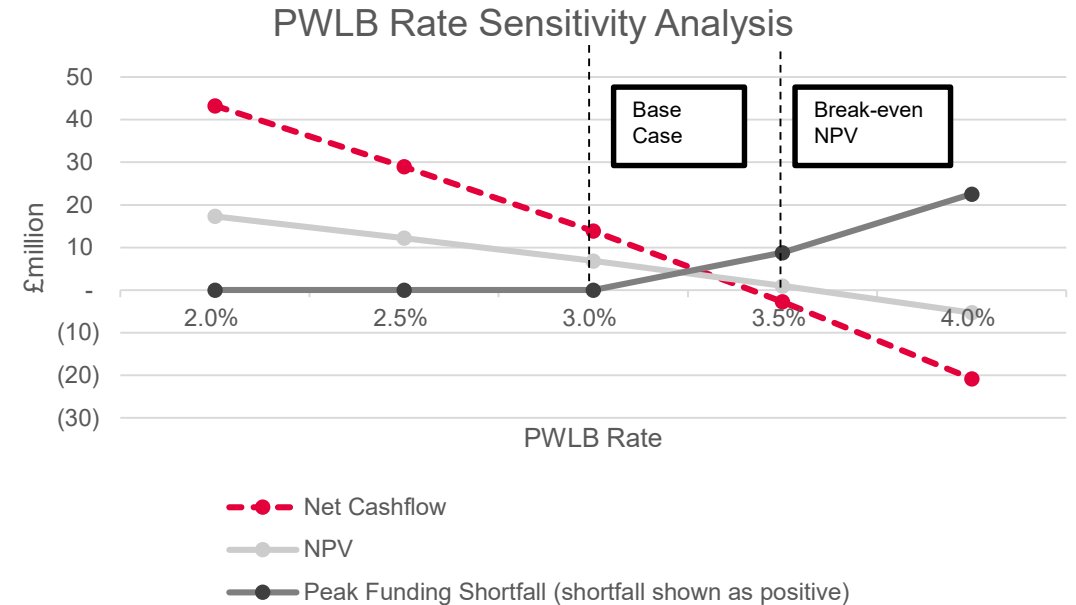
**Comments (to be completed by the Town)**

# Net Present Value

**Net Present Value (NPV) is the value of all future cash flows before financing (positive and negative) over the entire life of an investment discounted at an appropriate discount rate.**

## WHAT GOOD LOOKS LIKE

- A positive NPV indicates the amount of project funding reflects a present value of future cashflows that generates a surplus.
- For major capital projects, a positive NPV may indicate an investable project but the degree to which it is positive will indicate the levels to which it can absorb downside scenarios, such as cost overruns or increases in funding rates. This can be tested by running sensitivity analysis on the identified project base case.
- The following graph illustrates, as an example, sensitivity analysis testing on project borrowing rate and the effect on total net cash flow and project NPV.



## Comments (to be completed by the Town)

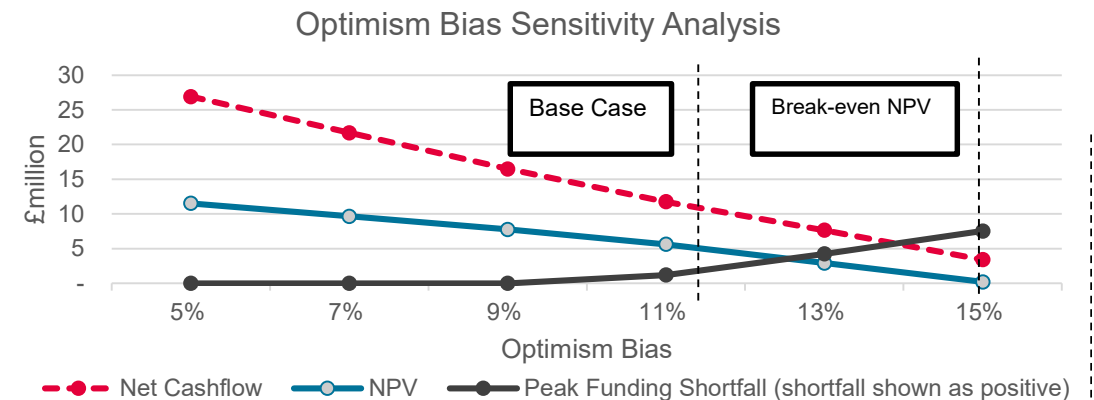
# Optimism Bias

This is a factor which is used to reflect an appraiser's unconscious bias in under-stating project cost items or overstating income lines in development appraisals.

## WHAT GOOD LOOKS LIKE

- The level set for optimism bias is based on the project type, the stage the project is at and whether specific cost elements have already been included.
- For example, if there is planning permission included in the development appraisal, this can lower the level of optimism bias for a project.
- HMT Green Book provides a range of optimism bias deflation percentages to remove any implied bias on capital costs, as illustrated in the table below based on project. This is illustrated further in the following graph, which shows how the different levels of optimism bias affect project NPV.

Project type	Upper level	Lower level
<i>Standard buildings</i>	24%	2%
<i>Non-standard buildings</i>	51%	4%
<i>Standard civil engineering</i>	44%	3%
<i>Non-standard civil engineering</i>	66%	6%
<i>Equipment/development</i>	200%	10%
<i>Outsourcing (operating expenditure)</i>	41%	0%



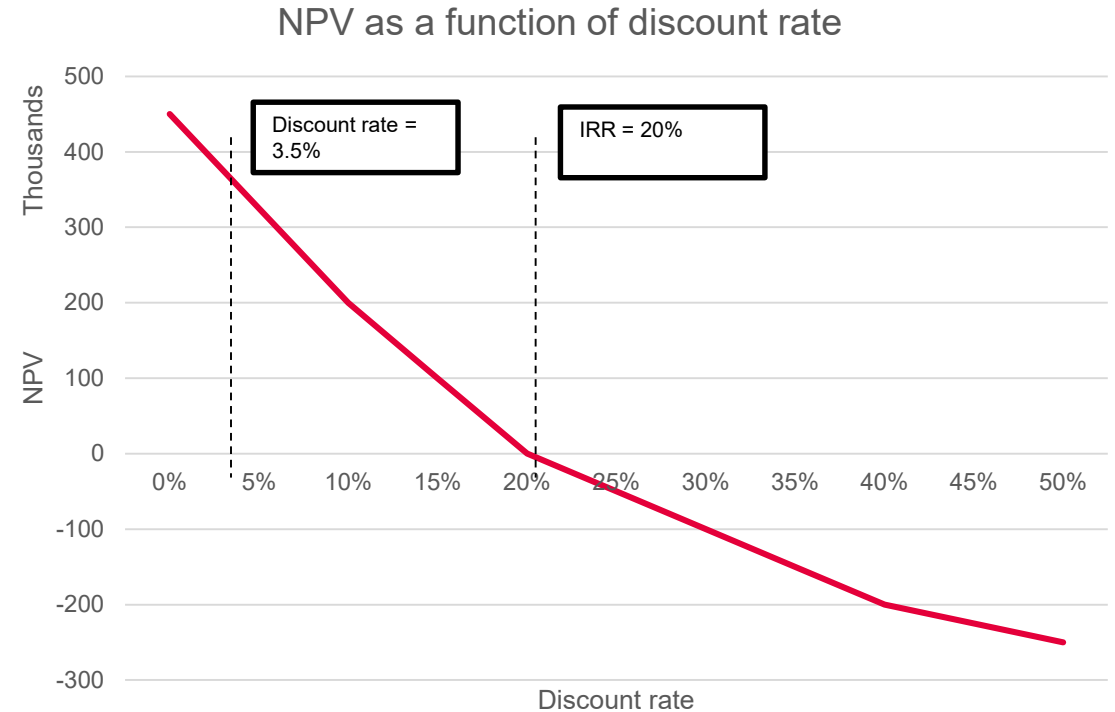
## Comments (to be completed by the Town)

# Internal Rate of Return (IRR %)

This represents the discount rate which would be applied to generate the project NPV to be £nil. Please note that this is a percentage and does not represent matters in absolute £ terms.

## WHAT GOOD LOOKS LIKE

- The greater the variance between the Internal Rate of Return and the discount rate as set out in the HM Treasury Green Book, the better the scenario for the project as this indicates a greater degree of scope to absorb risk.
- The following graph shows the effect of an increasing discount rate where the IRR% will have to increase to 20% before NPV = £nil.



### Comments (to be completed by the Town)

# Profitability

This assesses the surplus that can be generated from an intervention. This can be measured using quantifiable methods, such as considering gross and net profits, profit margins and net cash flows.

## WHAT GOOD LOOKS LIKE

- Good profit margins are based on the forecasts used and often linked to the sector of the project. The Town should aim to generate operational profits on yearly basis and aim for an increasing profit margin, especially after upfront development costs and any linked finance costs are met.
- Other financial ratios relating to gearing and liquidity ratios should be considered alongside profitability.

Ratio	Description
<i>Gross Profit Margin</i>	Gross Profit / Total Revenue (%)
<i>Operating (Net) Profit Margin</i>	Operating Profit / Total Revenue (%)
<i>Return on Equity</i>	Profit After Tax / Total Share Capital & Reserves
<i>Return on Assets</i>	Profit After Tax / Total Assets
<i>Return on Capital Employed</i>	Earnings Before Earnings and Tax (EBIT) / Total Assets less Current Liabilities (%)

## Comments (to be completed by the Town)

# Return on Investment

**This measures net profit against the total level of investment in the project. This is used as a performance measure to evaluate the efficiency of funding sought for the project.**

## WHAT GOOD LOOKS LIKE

- Generally the higher the ratio, this means that net profit is high in relation to the amount of investment, thus indicating that the project is forecasting a profit that is proportionally high compared to the available funds invested.
- We note that the bigger the project, this may lead to greater investment needs and so it may be difficult for the project to generate strong net profits and thus a high ROI figure.

**Comments (to be completed by the Town)**

# SECTOR SPECIFIC METRICS

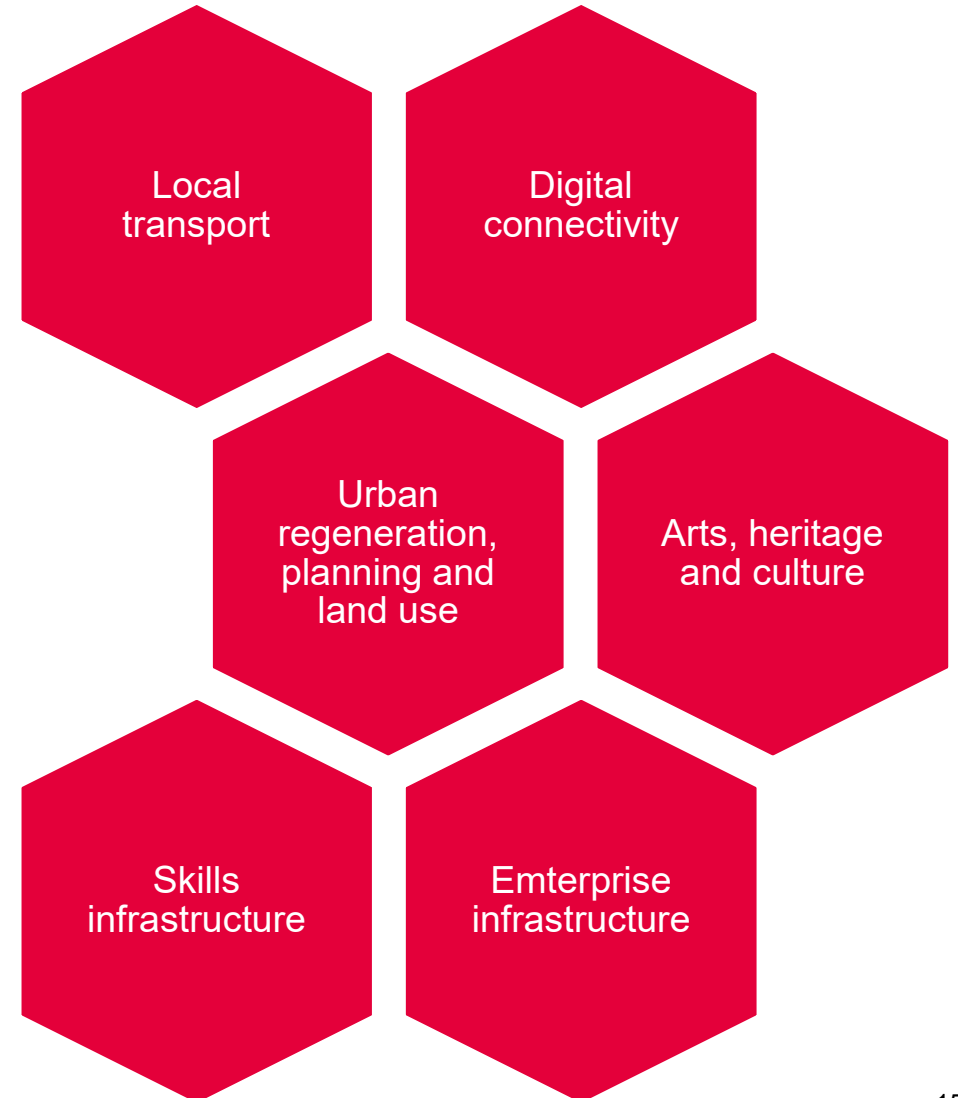
# Overview of sector specific metrics

**The following slides provide illustrative examples of the key sector specific metrics that the Towns may wish to consider for their interventions.**

We identify key areas for the sectors and example questions that the Towns may want to consider in setting key metrics, as well as the impact and outcomes for those considerations.

Once identified, the Town should include these metrics in its business case and outline key targets and performance indicators for the project to succeed.

Note that these can be tailored based on the Towns' needs thus at this stage we are unable to state "what good looks like" until further information is received.





# Local Transport

Below shows the illustrative examples of the key sector specific metrics for local transport projects

Type	Question	Outcomes
<b>Road / track length</b>	Will the project allow for a larger road/track network?	This will impact the number of ways that people can commute without experiencing greater traffic
<b>Fleet size</b>	Does the project allow for more buses/trams/trains?	This will increase the frequency of units and allow for faster commutes
<b>Number of commuters</b>	Has the growth factors been captured reliably?	This can impact commuters' accessibility for transport
<b>Number of stations / bus stops</b>	Are there enough to meet travel requirements?	This can impact commuters' accessibility for transport
<b>Method of commute</b>	How will the project impact the transport mix of the area?	This may highlight the need of meeting demand for a particular travel mode.
<b>Commuting time</b>	Will the project reduce average commuting time?	This will impact traffic and air pollution.

**Comments (to be completed by the Town)**

# Local Transport (continued)

Below shows the illustrative examples of the key sector specific metrics for local transport projects

Type	Question	Outcomes
<b><i>EV charging points / carbon credits</i></b>	Is there enough of an incentive for locals to switch to EV?	This will impact traffic and air pollution.
<b><i>Car ownership</i></b>	Have people own cars?	This will impact traffic and air pollution such that there is a need for EVs
<b><i>Bus / rail / tram fares</i></b>	Are these priced appropriately such that the Town generates income but does not attract negative reaction from locals?	This may affect locals' travelling routes.
<b><i>Pathways</i></b>	Are there enough pathways and pavements accessible for commuters?	This can reduce the amount of road and rail traffic.

**Comments (to be completed by the Town)**

# Digital connectivity

Below shows the illustrative examples of the key sector specific metrics for digital connectivity projects

Type	Question	Outcomes
<i>Population</i>	Has the growth factors been captured reliably?	Broadband speed and signal in various areas.
<i>Network points / fibre broadband / 5G</i>	Are these easily accessible for locals?	Broadband speed and signal in various areas.
<i>Battery cell numbers</i>	Is there enough to generate sufficient amount of power?	Lack of power can impact the operations of many businesses.
<i>WFH capability</i>	Can locals reliably WFH with uninterrupted WiFi?	This can impact efficiency where jobs allow for WFH capability and can affect wider areas such as road traffic.
<i>Solar panels</i>	Is there a focus on using renewable energy?	Reduction in power leverages and increase in usage of cleaner energy sources.

**Comments (to be completed by the Town)**

# Urban regeneration, planning and land use

Below shows the illustrative examples of the key sector specific metrics for urban regeneration, planning and land use projects

Type	Question	Outcomes
<b><i>Number of dwellings</i></b>	Will forecast unit numbers meet demand in the region?	This will help address any housing shortfalls.
<b><i>Average rental rates</i></b>	Will the project forecasts include comparable market rates?	Non-comparable rental rates can impact the Town's likelihood of renting out its units.
<b><i>Land / property values</i></b>	Are these measured at fair value using independent surveyors and are they comparable to surrounding land / property values?	Non-comparable values can impact the Town's likelihood of selling or renting out the assets.
<b><i>Grant availability</i></b>	Are these accessible from the likes of LEPs and HE?	This can allow for a smaller funding amount from third parties.

**Comments (to be completed by the Town)**

# Urban regeneration, planning and land use (cont)

Below shows the illustrative examples of the key sector specific metrics for urban regeneration, planning and land use projects

Type	Question	Outcomes
<b>Commercial units</b>	Given current economic situation, is there a demand to build commercial units?	There is a potential lost income opportunity if commercial units are built rather than residential units.
<b>Yield targets</b>	Are these in line with the Council's treasury prudential targets?	If not, these may not meet the Council's Capital Strategy objectives.
<b>Affordable housing</b>	Will new projects consider a fair proportion towards affordable housing?	This can meet its objectives as set out in the local housing plans.

**Comments (to be completed by the Town)**

# Arts, heritage and culture

Below shows the illustrative examples of the key sector specific metrics for arts, heritage and culture projects

Type	Question	Outcomes
<b><i>Number of visitors</i></b>	Have growth factors been captured reliably?	This can impact footfall and thus income levels for the Town.
<b><i>Number of landmarks</i></b>	Are there enough attractions to generate new visitors to the Town?	This can impact footfall and thus income levels for the Town.
<b><i>Sponsorship opportunities</i></b>	Can the Town generate additional income from partnering organisations?	This can reduce financial burden on meeting key financial metrics.
<b><i>Operator charges and commissions fees</i></b>	If the operations of the asset(s) is outsourced, what levels of charges and commissions will be charged to the Town?	The greater the fees and charges, the lower the level of net cash flow generated.
<b><i>Feedback from locals</i></b>	Has the Town factored in public consultations to gauge reactions to the project by locals?	Adverse reaction to the project will lead to increased reputational risk for the Town.

**Comments (to be completed by the Town)**

# Skills infrastructure

Below shows the illustrative examples of the key sector specific metrics for skills infrastructure projects

Type	Question	Outcomes
<b><i>Local unemployment rate</i></b>	What is the level of unemployment in the region and does the project allow to a fall in this figure? How does the rate compare to the national rate?	Job creations and regularly seeking to reduce unemployment rates will be high on local plan priorities.
<b><i>Local vs non-local employees</i></b>	Will the project allow for jobs for locals or allow for an attractive hub for those travelling from surrounding towns?	The project can aim to tackle the profile of the town by offering jobs which are attractive to people from surrounding towns.
<b><i>Schools / universities</i></b>	Will the project allow for the provision of specialist services, like an increase in the number of teachers, such that schools and universities can be at full capacity?	This will allow for more accessibility for pupils and address unemployment rates.

**Comments (to be completed by the Town)**

# Enterprise infrastructure

Below shows the illustrative examples of the key sector specific metrics for enterprise infrastructure projects

Type	Question	Outcomes
<b><i>Number of businesses</i></b>	Does the project allow for the generation of new businesses?	The Town can demonstrate a more entrepreneurial / start-up or up-scaling economic hub.
<b><i>Ages of working population</i></b>	Does the project allow for a greater proportion of younger workers, especially if the town is deemed to have an older working population?	This will allow for a younger working population with exciting new businesses, which may attract more visitors.
<b><i>Business births, deaths and survival rates</i></b>	Which is average life for new business start-ups? Is there sufficient support to allow for their survival after early years of trading?	Availability of grants for new local businesses should increase the number of start-ups in the town, which could boost the local economy.

**Comments (to be completed by the Town)**



# Glossary of terms

Term	Description
CPI	Consumer Price Index
Discount rate	The factor by which future net cash flows must be discounted by to obtain a present value (i.e. in today's terms).
Green Book	HM Treasury Green Book. <a href="https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf">https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf</a>
GT	Grant Thornton UK LLP
Indexation	Constant growth factor to reflect the time value of money in connecting future prices and asset values.
KPI	Key Performance Metrics
PV	Present Value
RPI	Retail Price Index

# Towns Fund

Delivery Partner

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