

Tackling a Capital Improvement Project:

FUNDING REPLACEMENTS AND MAJOR REPAIRS

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Housekeeping Note:

This is a “green” presentation. As such, paper handouts are not provided.

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Topics:

- **Capital Replacements versus Capital Improvements**
- **Project Funding & Sound Business Judgment**
- **When to Use Reserves, Special Assessments & Bank Loans**
- **Bank Loan Process**

What Is a Capital Component:

- Owned “in common” by the Association;
- Will require replacement or major repair;
- Has a finite Life (example: roof vs foundation)
- Not Maintenance or Operation expense.

Reference: Governing Documents, Board Resolution, Best Practices, GAP Report #24.

Capital Replacement versus **Capital Improvement**

Capital Replacement:

Replacement or major repair of existing capital component.

Capital Improvement:

New physical component not currently part of the community association.

“Perhaps the greatest
Duty of the Board of
Directors is to **Protect,
Preserve and Enhance**
the value of the homes
within the community!”



Robert Lyles, Esq. Charleston, SC

Meet Mrs. Jones...

- Retired school teacher,
- Lives on a fixed income,
- Has lived in her HOA for 20 years,
- As a member of the Board of Directors,
you are foreclosing on her home!



How Could This Happen?

Lack of Planning on the part of the Board!

- Resulted in a Special Assessment,
or
- Resulted in precipitous increases in Normal Assessments!

Funding options for Capital Replacements

- **Replacement Reserve Fund**
- **Increase Normal Assessments**
- **Special Assessment**
- **Commercial Bank Loan**

Replacement Reserve Funds

Pros:

- Is immediately available.
- Typically may be spent without vote;
- Doesn't require increased assessments*;
- No Interest.

Cons

- *May deplete Reserve Fund

Increase Normal Assessments

Pros:

- Can be done gradually over time;
- Less traumatic than Special Assessment;

Cons:

- May take time to build up to funding goal;
- May effect home values;
- May trigger delinquencies.

Special Assessment

Pros:

- Might be done relatively quickly;
- No interest

Cons

- May effect home values;
- May be unpopular;
- May require vote;
- May trigger delinquencies.

Commercial Bank Loan

Pros:

- May be done relatively quickly;
- May not require vote of membership;
- Does not deplete the Reserve Fund.

Cons:

- Association may not qualify;
- Requires interest payment.

Funding options for Capital Improvements

- ~~Replacement Reserve Fund~~
- Increase Normal Assessments
- Special Assessment
- Commercial Bank Loan

Important Note:

Whenever possible, **back the special assessment with a commercial bank loan!**

- Those that can afford the Special Assessment can write a check.
- Those that can't afford the Special Assessment can finance over time. (Remember Mrs. Jones?)

Protecting Property Values!

**TH Condo - 200 Units in 20 buildings.
Need new roofs and asphalt paving.**

- Option 1
 - Use existing Reserve Fund to complete 4 buildings per year over 5 years.
- Option 2
 - Use commercial bank loan to complete all at once.

Replacement Funding - Option 1:

Use Reserve Funds to complete 4 buildings per year over 5 years.

Pros:

- If adequate funding is available, may not require raising assessments
- Can be started immediately.

Cons:

- May deplete Reserve Fund;
- Will require long construction time;
- Inequity in who benefits first or last.
- Property Values not Protected!
- Inflation rate will result in higher material costs.

Replacement Funding - Option 2:

Use Special Assessment to complete project all at once.

Pros:

- Construction may be completed quickly;
- Everybody benefits equally!

Cons

- Property Values may be affected.
- Will probably be unpopular.
- Association vote may be required.
- May trigger delinquencies.

Replacement Funding - Option 3:

Use commercial bank loan to complete project all at once.

Pros:

- Construction may be completed quickly;
- Everybody benefits equally!
- Property Values protected.
- Other projects maybe included.

Cons

- Will require interest payment.
- Association may not qualify.
- May require a vote of the members.

Questions

Bank Loan Process

1. Underwriting Components
2. Application
3. Collateral
4. Typical Terms
5. Other Considerations
6. Interest Rates

1. Loan Underwriting Components

- a) Financial condition of the association
- b) Operating budget
- c) Balance sheet and income statement
- d) Reserve accounts
- e) Delinquency rate

1. Loan Underwriting Components (continued)

- f) Community documents
- g) Board minutes regarding the loan process are reviewed to ensure all legal conditions are met
- h) Number of rentals
- i) Unit value, age of the complex, and management stability

2. Loan Application

Most loans require additional financial information, including:

- a) Most recent interim financial statement
- b) Two years' year-end financial statements
- c) Current delinquency report showing 30-60-, and 90-day accounts
- d) Budget with statement of reserves
- e) Set of association governing documents (recorded copy)
- f) Board minutes approving loan request

2. Loan Application (cont.)

- g) Special assessment minutes and notice to unit owners if being repaid by special assessment
- h) Proof of insurance (declaration page showing association's property coverage)
- i) Construction contract or description of the use of proceeds
- j) Engineer's report (if available or required)
- k) Unit owner roster
- l) An attorney opinion letter

3. Bank Loan Collateral

- a) Banks normally do not mortgage the individual units or the association's common areas as security for these types of loans. Generally the units already have mortgage liens in place.
- b) The bank should require an assignment of the accounts receivable of the community association.

3. Bank Loan Collateral (cont.)

- c) Typical receivables consist of special assessments and monthly maintenance fees.
- d) The association is still responsible for collecting all receivables and taking action on delinquent accounts.
- e) The only time the bank should directly collect these receivables is if the association defaults on the loan.

4. Bank Loan Typical Terms

- a) For special assessment financing, the term of the loan usually is matched to the term of the collection of the special assessment.
- b) Payments are monthly or quarterly, and generally do not exceed a 10-year year period.
- c) During construction and large repair projects, interest-only payments may be permitted until the project is complete, followed by regular installment payments to reduce the principal.
- d) A line of credit or a draw loan also may be used whereby the client pays interest only on the funds drawn out.

4. Bank Loan Typical Terms (cont.)

- e) Simple interest installment loans also are made to finance hazard and flood insurance premiums.
- f) A line of credit or a draw loan also may be used whereby the client pays interest only on the funds drawn out.
- g) Simple interest installment loans also are made to finance hazard and flood insurance premiums.

5. Bank Loan Other Considerations

- a) If a bank holds an assignment of the receivables, that does not affect the daily operation of the association, such as selling a unit or other operating decisions.

5. Bank Loan Other Considerations (continued)

- b)** The bank also may lend money based solely on the association's operating budget. In this case, a special assessment is not required. However, the repayment terms typically are short.

5. Bank Loan Other Considerations (continued)

- c) The association may have the ability to pledge a certificate of deposit as collateral. Since the association is borrowing its own funds, the interest rates are very favorable.

6. Interest Rates

Interest rates vary depending on several factors, including:

- Dollar amount of the loan
- Repayment term
- Financial status of the association
- Amount of deposits at the bank

Questions?

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