

Lannock – Building Value in Strata Communities



Separate capital budgeting decisions from the means of funding

This article is the first in a series of valuation and funding issues in strata buildings.

For many people, the funding options for strata corporations have been quite straightforward: operating expenses should be paid by administrative levies and major items of maintenance or renovation should be financed by a sinking fund or a special levy. And that, they think, is simply that.

Strata corporations have always been able to borrow: the power to raise a loan is specifically provided for in legislation. However, in most states, strata corporations are not allowed to grant security (such as a mortgage) over the common property. And in most parts of the world, financiers making property loans will always insist on security; “no security, no loan” seems to be their motto.

With finance now available, there is new focus on the different ways a strata corporation can raise funds. Luckily, the world is not turned upside down: the options are as they have always been, and the issues strata corporations should consider are exactly the same. It's just that borrowing is now practical and so draws attention to the fundamental issues.

What issues should a strata corporation consider?

The first important thing is to separate the concept of “the building project” from the question “how do we pay for it?”

As any good finance director of a company (and a strata corporation is like a small company) will tell you, the budget for capital works, and the means of funding it, should be considered quite separately. In strata, you often hear people talking about their sinking fund as if it was their budget for capital works. This is a mistake and can be very misleading.

So then, what is important in the capital budget?

To answer that properly, we have to go back a step and ask: “What are you trying to achieve?” and “What is your vision for your building?”

These are important issues – Lannock believes that, ultimately, the objectives of every owner of a strata unit can be embodied in just two concepts: capital value and lifestyle. These objectives are the same for both investors and owner-occupiers.

All owners are interested in capital value: the price you expect to get when you sell your unit is just as important for the investor who turns their portfolio over regularly as it is to the owner whose unit will be part of their estate when they die.

It's the same for lifestyle. The look and feel of the building, as well as how efficiently its services run, determines how much people enjoy living there. This is obviously important for owner-occupiers, but is critical for investors. Lifestyle determines rents which drive yield and return on investment.

There are simple questions unit-owners can ask: “If you were to spend \$10,000 on the inside of your unit, how much would you get?”, “How much happier would you be?”, and “How is lifestyle enhanced for the occupier and what is the increase in rental return and capital value for the owner?”

Now, think about what would happen if everyone spent \$10,000 each on the common areas of the building? By how much would capital value and rental return increase and how much happier would you be?

Some people like to go as cheap as possible and minimize each and every expenditure, including major capital works. But we all know what happens when you buy cheap. Others want to over-capitalise, to put more into a development than they are ever going to get back. Obviously, this is also folly. So where is the solution?

It's very simple. The real objective for your capital budget is to ‘optimise’: to find the right level of works that will provide a good long-term solution. We are looking for the optimum combination of increase in capital value (and rental return), enhancement of life-style, initial outlay and maintenance expenditure over time. Minimizing the initial outlay often places a ceiling on capital value and leads to disappointments in living standards and increases future maintenance expenses.

In future articles we'll cover the advantages and disadvantages of sinking funds, special levies and borrowing as well as investment policies and strategic plans for strata corporations.

Many people think sinking funds are a gift from the gods, but we'll investigate their advantages and disadvantages and calculate the cost to owners of the benefits that sinking funds provide.

People also dislike special levies, but we'll look at their specific issues and show that they are often a good solution.

And, of course, we'll cover debt: how to calculate the true cost, what traps to look for in a loan agreement, and when to know if this is the best option in your particular situation.

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