Condo Insights

#30 – The impact of current economic conditions on community and condominium associations – Part 4

This multi-part series looks at the impact of current economic conditions on community and condominium associations. Simply stated: seashore condominium associations can expect to pay higher prices for goods & services and unit owners can expect increases in HOA maintenance fees.

This column will review how major projects and capital reserve studies are affected by inflation and offer suggestions on what Association Boards should consider in this current economic environment.

Community and condominium associations have two distinct financial plans - an annual operating budget and a multi-year long-term capital reserve plan. Condo Board Members quickly recognize how inflation has increased expenses in the Association's annual operating budget.

Inflation is also increasing costs of capital replacement projects, making long term planning much more uncertain. Higher costs to perform major maintenance and replacement projects could drain an Association's Reserve-for-Replacement and Periodic Maintenance accounts. How should an Association deal with such situations?

A capital reserve plan identifies association assets; forecasts the estimated useful service lives of association assets and estimates how much it will cost to replace, rehabilitate, or modernize these assets. Capital reserve plans also forecast expenses for building façade inspections, exterior coating and waterproofing projects and other significant maintenance expenses that occur less frequently than annually and therefore are not included in the operating budget.

The primary purpose of a reserve study is to provide associations with a comprehensive short and long-term capital plan. Reserve studies generally account for a 2 or 3% inflation factor. In the current economic environment, higher rates of inflation should be considered. Inflation is affecting capital planning efforts for associations for both the cost of goods & materials and the cost of labor. Building materials are increasing in price. Due to increases in oil costs, petroleum-based products like asphalt are also rising in cost. Along with rising material costs comes rising labor costs.

An Association's existing capital reserve funding plan may not be adequate or may be prematurely outdated and need to be updated. Associations should be planning one to two years out, re-prioritizing projects, updating capital financial projections and adjusting reserve contributions. Bids for capital-intensive projects may be much higher than originally forecast. While it may seem counter-intuitive, the Association may be wise to incur additional expense for professional guidance throughout a major project to review and evaluate bids, monitor contractor performance, and control overall project costs.

Should an Association update their capital reserve study? The reserve study should be updated if it's 5 years or older. If the reserve study is less than 5 years old but there are no major projects scheduled in the upcoming few years, the Association can likely wait until the study is 5 years old to update. If major capital projects are scheduled in the upcoming 2-3 years, financial projections for these upcoming projects should be updated.

When funds are limited, should an Association postpone or delay a major project, and how does an Association decide which projects should be performed and which can be postponed? Safety and infrastructure-related replacement projects take priority over projects that are aesthetic or recreational in nature. Priority should be placed on projects that would cause additional damage if delayed or substantially higher replacement costs if deferred. A roof replacement project should probably not be delayed if the current roof is leaking and causing damage within the building. Associations can evaluate the need and timing for discretionary projects. Upgrades to interior hallways, bathrooms or other common areas can be delayed or deferred until inflation subsides.

When contemplating major capital projects, Association Board members must consider not only the Association's current and future financial situation but consider the financial situation of their members. Board members must recognize how inflation is affecting their Association as a whole while being sensitive to their member's financial status and position. If projects are expected to be much more than originally forecast, how will the Association pay for the increase? Will HOA maintenance fees have to be increased to allow for greater reserve funding? If so, can the increases be phased in over a number of years? Phasing in increases may be one way to minimize the financial burden on members.

Could the Association obtain a loan to minimize short term increases to reserve contributions? A loan can help Associations complete crucial projects as originally planned while also offering residents payment flexibility including time to recover from financial strain caused by higher HOA fees.

According to a recent survey for the Foundation for Community Association Research, 91% of association managers professionals and homeowners surveyed report they are seeing unexpected increases in expenses due to rising costs and inflation. When asked how they plan to address the unexpected costs, 73% of respondents report they plan to raise HOA maintenance fees while 41% say they plan to reduce expenses and 15% will lower reserve funding contributions. Lowering reserve funding contributions in an economic environment where capital project costs are increasing is only going to delay a financial reckoning for the Association.

The survey reports that some Associations will defer maintenance projects, reduce landscaping expenses, and reduce community programs. Additional responses include renegotiating contracts, prioritizing projects, investing in energy efficiency, using contingency funds, implementing special assessments, and exploring bank loans.

Especially in times of economic uncertainty, board members should refocus attention on the financial activities for their Association. Association investments should be 100% insured. The last thing you want to have happen now is to compound fiscal challenges by losing money on your investments. If possible, pay insurance premiums in full to avoid incurring interest expense. Association board members need to closely monitor operating expenses, build cash reserves, make sure capital reserve plans are up-to-date and that insurance valuation appraisals accurately reflect your Association's reconstruction cost.

Jim Yost owns Elite Management and Advisory Services, LLC and is managing partner for Ocean Property Management Corporation, based in Wildwood. The firms manage numerous community, condominium, and homeowner associations in southern New Jersey. He can be reached at yostopmc@comcast.net. Past columns are available online at www.oceanpropertymgmt.com.

Karim Kaspar, Esq. is Senior Counsel with Lowenstein Sandler LLP. He serves as general counsel to numerous community and condominium associations throughout New Jersey. He specializes in complex commercial litigation and real estate matters and has been active and instrumental in the firm's pro-bono activities. He can be reached at kkaspar@lowenstein.com.