FirstService
RESIDENTIAL

BUILDING TO LAST

a blueprint for success

Capital improvements increase the value of your community.

When you live in a towhome community, strata or condominium, capital improvements are a fact of life. Yet as crucial as these major upgrades, replacements and repairs are, many council members struggle with the complexities they present. This guide will help you better understand capital improvements, including their relationship to preventive maintenance and the value of having an up-to-date depreciation report. You'll also learn about different funding options and the key elements of a successful capital improvement plan.

What Defines a Capital Improvement?

If you find capital improvements confusing, you're not alone. One reason is that some communities distinguish between "improvements" that require a homeowner vote — such as adding a tennis court — and "repairs and replacements" that do not — like replacing a roof. In addition, some states and provinces have their own definition that communities must use.

The best way to know how capital improvements need to be defined and approved for your strata is to check with the corporation's governing documents, legal counsel and/or accountant. Here is a general definition that applies to many communities:

> *A capital improvement is a major replacement or repair that will increase a component's market value beyond its original or current state. In general, it is intended to lower future operational costs (such as maintenance or utility costs) or enhance residents' quality of life.*

Capital improvements are meant to last more than a year and usually cost over $10,000. However, they can also save your community money in the long run and increase property values.

Preventive maintenance: capital improvement's close cousin

In contrast to capital improvements, preventive maintenance jobs are less costly and are performed more frequently. They are funded from your corporation's operational budget under the line item "Repairs and Maintenance (R&M)," and they are meant to restore your major components (or "assets") to their original condition or prevent them from deteriorating further.

Following a component's preventive maintenance schedule as recommended by the manufacturer or contractor increases its likelihood of reaching or exceeding its expected useful life — that is, the estimated amount of time it will serve its intended purpose. The more you can stretch a component's useful life, the longer you can go before it needs to be replaced or requires a major repair, which translates into more savings for your community.

However, there are caveats. "When you get toward the end of an asset's useful life, repairs sometimes can be more expensive than replacing the asset," explains Tal Eyal, president of FS Project Management. "If the cost of maintenance is close to or more than the replacement cost, it's time to replace the asset. The item might even be tax deductible or you may get a tax incentive." It may also be worthwhile to replace an asset rather than repairing it if the replacement comes with a manufacturer's warranty, has a longer life expectancy or is more energy-efficient system or mechanical equipment, all of which could save the strata corporation money.

Some maintenance jobs can turn into capital improvement projects unexpectedly. For example, roof damage could appear to require a simple repair, but further inspection might reveal that the entire roof needs to be replaced.

The role of depreciation reports

A depreciation report enables you to plan and budget for capital improvement projects over the next 20 to 30 years. A specialist from a report provider (preferably an engineer) should conduct the study, which consists of:

» **A physical analysis.** The reserve specialist performs a site inspection to determine the condition of your existing components, estimates their remaining useful life and makes scheduling recommendations for their repair or replacement.

» **A financial analysis.** This entails estimating the cost for each repair or replacement as well as any additional improvements (like adding a playground or expanding your fitness centre). Based on these costs and your current reserves, the reserve specialist recommends a funding plan and calculates the monthly contribution required from each homeowner.

In most areas, the developer would have provided your community with an initial depreciation report at the time the property was transitioned to a resident council, but you should update the report regularly. "Some states and provinces have laws mandating the frequency," says Drew Ahrensdorf, vice president of FirstService Financial. "Even if yours doesn't, you should get your depreciation report updated every 3 to 5 years and upon completion of any capital improvement projects." It's also important to have the report reviewed annually to make sure the recommended funding is still accurate. Factors such as increases in labour or material costs, unexpected events and changes in the number of fee delinquencies can alter your funding needs.

You should get your depreciation report updated every 3 to 5 years.

Since a depreciation report isn't a detailed scope of work, you should also plan to get a comprehensive "conditions study" or "conditions assessment" about 1 to 2 years before a component is expected to reach the end of its useful life. The level of detail it provides will give you a more accurate picture of the work and cost involved. Local experts, such as contractors, engineers and architects, can provide this.

Be careful publishing or circulating a depreciation report or conditions study as a formal strata document, however. In some provinces, if it is issued and relied upon by prospective purchasers, the corporation could be at risk of legal liability or claims of misrepresentations due to inaccurate forecasting or cost analysis that may require additional funding by the corporation and its members. For this reason, it's always prudent to check with your strata's attorney or accountant before memorializing a depreciation report. One way to address this is to keep keep these documents in "draft" form so they won't be disclosed with the corporation's financial statements.

Will That Be Cash or Credit?

Once you're ready to start a project, you need to determine how your community will pay for it. You have several options:

Your reserve fund

The first source you should tap into is your strata's reserve fund. Hopefully, you've been following your reserve study's recommendations and putting the appropriate amount of money aside. Choosing the right type of account for your reserve fund is important, too. Since your council has a fiduciary duty to your homeowners, it's imperative that you protect the money they are entrusting you with. However, that doesn't mean putting it in a checking account that yields no interest. "We've helped many communities significantly increase their return on investment just by moving their reserve money to higher-yielding — but safe — accounts, like CDs," says Ahrensdorf.

What if you don't have enough in your reserves to cover the cost? Unfortunately, many communities don't adequately fund their reserves.

Councils are often reluctant to increase assessment fees in response to rising costs because of the reaction homeowners are likely to have. Since funding day-to-day operations is a more immediate need, they attempt to reduce expenses by decreasing the amount they set aside to fund future projects.

Besides leaving you with an inadequate amount of money for needed repairs and upgrades, underfunding your reserves can have other serious consequences. For one thing, it can negatively affect property values. In addition, it can dissuade prospective homebuyers from moving into your community or strata, especially those who plan to pay for their home with a Federal Housing Authority (FHA) loan. A buyer won't qualify for an FHA loan if the corporation isn't allocating at least 10% of its operating budget for its reserve fund.

Even if your community has been diligent in funding your reserves, you might come up short if, for example, an unforeseen event not covered by insurance causes significant damage that must be addressed immediately. Or your council may realize that adding desirable amenities is the only way to compete with communities or stratas being built in your area. Whatever the reasons for your shortfall, you do have other funding options, which you can use individually or in combination.

Special assessments

You probably already know one of the primary downsides of a special assessment: It can cause discord within the community, especially if you are also increasing fees to cover shortfalls in the corporation's operating budget. The upside, however, is that once the work is completed, there's no debt left to repay.

Residents are usually more willing to pay a special assessment if they will benefit directly from the work or if they understand the reason it's needed. Offsetting the financial burden by allowing residents to pay it in installments can also make a special assessment more acceptable. Keep in mind, however, that since you won't have the entire balance of the special assessment right away, you may have to either delay work until you do or align installments with the contractor's periodic payments.

Loans

Loans have become increasingly common for funding capital improvements in recent years, a trend that has been mirrored at FirstService Financial. "In 2012, only 2 communities asked us to help them secure a loan," notes Ahrensdorf. "In 2018, that number rose to 78 as the financial landscape became more stable."

One of the advantages of taking out a loan is that you have the money immediately. A loan can also help you fill a gap in your reserve fund or in the amount you're able to collect up front when homeowners pay a special assessment in installments. You can even take out a loan for the full amount of the project and then use a special assessment to pay it back.

Increased assessment fees

Raising the amount homeowners pay for their regular assessment fees so you have more money in the budget to allocate to your reserve fund is another way to cover the cost of a capital improvement project. This option may be the least popular among homeowners, but it can provide your corporation with additional money for an upcoming project and to grow your reserve fund for future projects.

Insurance

Although insurance can't pay for a planned capital improvement, inadequate coverage can result in unanticipated capital expenses. Make sure you are properly covering assets that may be susceptible to damage from weather or other mishaps.

Planning for Success

Capital improvements not only affect your community or building's health and reputation but also homeowners' wallets. That's why you need to prioritize projects appropriately and communicate with community members from the beginning. It's also crucial to create a plan prior to starting each capital improvement project, to have a professional managing the project and to communicate with residents about the project's status as work progresses.

Communicating with residents

Lack of transparency is a common complaint residents have about their councils. When a council fails to communicate adequately about something as costly as a capital improvement project, residents often respond with anger. Even if a project is essential, clearly explaining the reasons may be all it takes to gain residents' acceptance. Additionally, sending out surveys to get resident feedback about what projects are important to them demonstrates that the council values their opinions.

Keep residents informed about the council's capital improvement plans by discussing them in meetings and using any other communication channels available: emails, your community website, newsletters, flyers and mass communication tools. Getting buy-in from residents helps projects proceed more smoothly.

Regular, relevant and timely communications are also important during capital improvement projects so homeowners are aware of work that's in progress, how it might impact them individually or as a community and when it's likely to be completed. This helps manage expectations and helps them feel like there's an end in sight.

Prioritizing projects

For the most part, your components' remaining useful life determines the timing of your capital improvement projects. For instance, a component that is coming to the end of its expected useful life next year will probably need to be replaced before one that is expected to last another 5 years. But what if several components are reaching the end of their useful life simultaneously or you also have several enhancement projects you want to do?

Of course, you need to prioritize structural work over those projects that are simply aesthetic or nice to have. Beyond that, however, prioritization depends on the asset. Let's say you're looking at projects for the exterior of a building. "These projects would be categorized into 3 classes," according to Eyal. "The first group would be those projects that have to be done, like replacing the façade. You have no choice because it presents an imminent danger," he explains. "The second group would consist of those projects that make sense to do, such as an outside leak. And in the third group you would have your wish-list items."

Whenever possible, you should give residents a voice in how you'll prioritize projects. Your council may think that repaving your parking lots should take precedence because you've heard some residents complain about cracks and potholes. A survey might reveal that, in fact, outdoor lighting upgrades are a higher priority for residents because they are more concerned about safety. Your council wouldn't know this without asking the entire community or building.

Defining a project's scope and timeframe

When you're ready to start planning a specific capital improvement project, consider the advantages and disadvantages of various approaches. If you work with a strata management company, you may be able to visit other properties the company manages where similar work has been performed. This could reveal that there's a lower-cost way to do the project, or you may realize that investing a little more money provides an option with significantly greater benefits.

Decide when to start the project by working backward from when you want it completed. Be sure to take into consideration weather, holidays and times when occupancy might be high or low. Remember to build in time for delays caused by any of these factors, too.

Hiring a project manager

By providing construction management services from concept to completion, project managers can significantly reduce the burden on your council and strata manager. Their expertise enables them not only to oversee capital improvements, but also to optimize the value of your projects (value engineer). Their job is to advocate on behalf of the community to decrease total project time and cost, in part by leveraging their existing resources and relationships to purchase goods and services at a lower price. They are also responsible for keeping the project running smoothly and ensuring that work meets quality standards and code.

Project managers are usually engineers or other construction professionals with years of experience. It's important that you not make the mistake of expecting your strata manager to act as the project manager since strata managers do not have the same expertise. Their role is to keep operations running, not to oversee capital improvement projects, and they can't do their regular job properly if they are also expected to manage those projects, too.

Soliciting bids

Both your project manager and your strata manager can help identify reliable vendors and contractors. In addition, the councils of other properties the company manages may be able to recommend providers they have used. A good strata manager will also be able to minimize the complexities of soliciting bids by taking on the job of interviewing and negotiating costs with engineers and contractors. A large strata management company that has a strong local presence is also likely to have a list of vetted providers you can choose from and vendor relationships you can leverage.

Make sure that all vendors and contractors have necessary licenses, certifications and insurance coverage and that they offer warranties for their components and the work they perform. You should also check with your corporation's attorney about any potential liability you may face during the project and determine whether you need to obtain any additional insurance during the work. For example, your corporation could be liable for theft or damage to tools, supplies and other items a contractor stores on-site while work is ongoing.

Updating your reserve study

Once the project is over, you'll need to bring in a specialist to update your depreciation report. The existing report will have become out of date because you'll have depleted some (or all) of the money in your depreciation report and completed one of the projects listed in the report.

How Well Do You Handle *Capital Improvements?*

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Use the following checklist to find out where your community stands.

YES	NO	
☐	☐	▶ We have an up-to-date depreciation report that was conducted by a qualified depreciation report specialist.
☐	☐	▶ Our depreciation report is reviewed annually for financial accuracy.
☐	☐	▶ Our reserves are more than 70% funded.
☐	☐	▶ We have the money we need for our next capital improvement project.
☐	☐	▶ Our reserve fund is kept separate from our operating fund and is earning interest.
☐	☐	▶ We follow the recommended preventive maintenance schedule on all our components.
☐	☐	▶ We solicit resident feedback to find out which capital improvement projects are most important to them.
☐	☐	▶ We keep residents informed about the status of ongoing capital improvement projects.
☐	☐	▶ We openly discuss upcoming capital improvement projects — including funding issues — at council meetings, and provide information through our other communication channels.
☐	☐	▶ Our capital improvement projects are overseen by an experienced project manager.
☐	☐	▶ We work with a strata management company that helps us solicit bids and determine how we should fund our capital improvement projects.

Capital improvements can be complex, but understanding them better will help you make better decisions for your community. Keep this guide as a reference so that your council can hit the ground running when you're ready to start your next project.

Want more advice from a company that understands what it takes to plan your capital improvement projects? Contact FirstService Residential today!

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About FirstService Residential

FirstService Residential is North America's largest manager of residential communities and the preferred partner of HOAs, community associations and condo and strata corporations in the U.S. and Canada. FirstService Residential's managed communities include low-, mid- and high-rise condominiums and cooperatives; single-family homes; master-planned, lifestyle and active adult communities; and rental and commercial properties.

With an unmatched combination of deep industry experience, local market expertise and personalized attention, FirstService Residential delivers proven solutions and exceptional service that add value, enhance lifestyles and make a difference, every day, for every resident and community it manages. FirstService Residential is a subsidiary of FirstService Corporation, a North American leader in the property services sector. For more information, visit www.fsresidential.com.