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WHEN SHOULD AN ASSOCIATION CONSIDER A BANK LOAN FOR PROJECT-SPECIFIC FINANCING?

By James M. Nigro
Senior Vice President, Somerset Hills Bank



(As a service to our readers, we periodically provide information from guest contributors on important and timely topics. James Nigro has over 12 years of commercial lending experience, which includes 5 years of specialized experience advising Associations and Management Companies on project finance matters. Mr. Nigro can be contacted for more information at james.nigro@bankofsomerset hills.com.)

Background and Perspective

Boards face a real challenge when determining the appropriateness of using bank loans as part of a strategy to fund Capital Replacement projects. Much analysis and consideration of the impact on the Association's membership must accompany these decisions.

There is a growing recognition among financial institutions of the safety inherent in lending money to Community Associations, based on an Association's rights to assess and enforce collection of fees. Common misconceptions and prejudices once prevalent among bankers, such as objections related to the inaccurately characterized "unsecured nature" of community financing, have given way to competition for loans of this type. This more favorable perception by bankers and increased competition for loans, has led to significantly reduced borrowing costs for Associations.

The implication is that there will be circumstances in which it is both appropriate, and advantageous to an Association to consider a loan as part of a Capital Replacement project funding strategy. This article presents an overview of the key guidelines and issues to be addressed in considering Capital Replacement financing strategies.

To place capital project financing in perspective, some definitions are necessary:

◆ *Capital Replacement*-refers to the repair/replacement of **existing common, and limited**

common elements such as roofs, siding, sidewalks, etc.

◆ *Capital Improvement*-is the planned *improvement* of the Community's infrastructure by adding **new** structures, amenities, (a new pool, clubhouse, tennis court, tot lot), etc.

Because Association Boards have a fiduciary responsibility to replace common and limited common elements, as a practical benefit to our readers, this article will focus on financing options of Capital Replacement projects. Boards have three primary potential sources of funds to pay for Capital Replacement projects:

1. Use of existing reserve funds (monies accumulated in the Capital Replacement fund)
2. Special Assessments
3. Loans to the Association.

It is a Board's challenge to determine the appropriate financing approach on a project and situation-specific basis. With these factors and challenges in mind, consideration should be given to the following:

- ◆ **Potential Scenarios Where a Bank Loan May be Appropriate**
- ◆ **Issues a Lender May Consider in Evaluating Whether to Make a Loan**
- ◆ **Typical Loan Structures**
- ◆ **An Outline of the Criteria to Consider in Selecting a Lender**

Potential Scenarios Where a Bank Loan May be Appropriate

In tackling a capital repair or replacement project, bank financing can be a viable, and in many cases prudent, alternative to other unpleasant choices. These less than desirable circumstances include:

- ◆ Depleting capital reserves to the point at which they would not be sufficient to cover the cost of other impending replacement projects

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- ◆ Passing a large unaffordable special assessment
- ◆ Stretching project completion out over an extended period of time.

Borrowing can be used in conjunction with existing Capital Replacement monies and/or special assessments to fund significant unanticipated major repairs or replacements on an accelerated schedule.

What are the benefits of financing in these particular situations? If capital reserves are already depleted, borrowing

may be the only practical way to obtain funds without passing a large one-time assessment. This may be a financially burdensome alternative for unit owners, particularly for those living on a fixed income. Additionally, there are economic advantages and quality of life values to the membership when the entire project can be completed at one time. The project will invariably be cheaper (and less frustrating) than having the contractor continually return to the job, and the uniformity of the exterior appearance is of greater appeal to both current residents and prospective unit owners.

The following table highlights three common scenarios in which an Association might consider a loan as part of its Capital Replacement funding strategy:

Scenario	Example	Potential Benefit to the Association
The annual maintenance cost of the item would exceed the annual debt service.	Replacing deteriorating wood with vinyl siding.	Siding replacement is cheaper than maintenance of existing siding.
The replacement cost of an item significantly exceeds the cost estimate anticipated in the engineering study.	Association reserves for the replacement of shingles, but sheathing underneath the shingles also requires replacement.	Reduces the size of a special assessment or the depletion of existing reserves.
The replacement of the item occurs significantly sooner than anticipated by the engineering study.	Roof or siding deteriorates sooner than expected.	Reduces the size of a special assessment or the depletion of existing reserves.

Issues a Lender May Consider in Evaluating a Loan

(NOTE: The discussion that follows focuses on project-specific financing. Other types of loans, such as revolving credit lines and working capital loans, are beyond the scope of this article.)

First and foremost, the lender will look to evaluate the stability and continuity of the Association's past, current and future cash flow. The lender will give considerable attention to the amount of the increase in assessment fees needed (if any) to cover debt service. If this fee increase is too great, it may result in increased unit-owner delinquency. Additionally, a lender must consider the total level of assessment; it should also be reasonably consistent with fees levied for comparable communities in the Association's local market. Review of a current reserve analysis must evidence that the level of reserves remaining upon completion of the project, together with budgeted annual contributions, will be adequate to meet future replacement needs through the term of the loan. The need to borrow additional funds or pass a special assessment during the loan term may strain unit owners' abilities to maintain timely payment of assessments.

In addition to the Association's financial situation, the lender will also look for broad community support, evidenced by a high percentage of owners voting in favor of the project or fee increase. In the absence of a vote, the lender will want to review minutes from Board meetings to gauge owner receptivity. The existence of organized opposition, and current or potential litigation can divert attention from successful project completion, and can negatively impact cash flow, thereby impairing loan repayment. Additionally,

an Association should plan to obtain a legal opinion from its Attorney to indicate that the Association is authorized to borrow funds.

There are other factors that a lender must consider. Some of the situations that might increase a lender's concern, thus making it more difficult for a loan to be granted, include:

- ◆ High ratio of investor-owned units
- ◆ Concentration(s) in unit ownership
- ◆ High delinquency rate on assessments
- ◆ Small Associations where the risk of repayment is not sufficiently diversified
- ◆ A significant number of foreclosures, bank or government owned units
- ◆ Repayment relying on collection of funds outside the Board's control
- ◆ History of annual operating deficits and/or multiple special assessments.

The lender will also conduct a thorough review of the qualifications and capacity of the contractor, the adequacy of the project budget, and the plan for project supervision. This entails checking references, credit reports and insurance coverage on the contractor, as well as, conducting a detailed plan and cost analysis, typically performed by an independent consulting engineer engaged by the bank.

Typical Loan Structures

The loan is made directly to the Association, usually without personal guarantees by Board Members. It is typically secured by an assignment of, and security interest in, all future assessments payable by the unit owners to the Association, together with an assignment of the Association's collection and enforcement rights during the life of the loan.



If regular assessments are insufficient to cover debt service, a special assessment sufficient to repay the loan in full will need to be passed, and assigned to the lender as collateral. Additionally, it is common for lenders to require a collateral assignment of a cash account, often equal to two or three months of debt service, as a reserve against future payments.

Most lenders restrict the amount of a project's financing to 75% of the total cost, including an allowance for cost overruns of anywhere from 5% to 15%, based on the scope of construction. The balance of the project cost not covered by the loan represents cash equity that must be contributed by the Association prior to the release of loan funds. This cash contribution can come from the Association's Capital Replacement fund, other Association funds, a special assessment, or a combination of these.

For projects requiring progress payments to the contractor, the loan can be structured with an interest-only draw down period, coupled with a floating rate of interest. Funds are advanced (and interest charged only on the balance outstanding) as construction progresses, subject to inspections performed by a consulting engineer engaged by the lender. Upon successful completion of construction, the loan is converted to a term loan with repayment terms of three to seven years. Repayment should be based on equal monthly payments of principal and interest with a fixed rate of interest, to allow for a fixed annual requirement to be included in the Association's annual budget.

Interest rates vary by (among other things) lender, loan size and term. An analysis of these variations is beyond the scope of this discussion, but one basic concept is worth mentioning. If the construction period is relatively short, the loan can be fully funded into an interest-bearing escrow account with the loan interest rate fixed at closing. The loan funds can then be disbursed from escrow as construction progresses. Although there is a negative interest rate spread incurred by the Association during construction, interest rate risk is reduced. In other words, the interest income the Association earns on the funds in the escrow account is less than the interest expense on the loan. Although this might appear unattractive, this strategy may be particularly wise in a

rising interest rate environment, because it allows the borrower to fix their borrowing costs for the life of the loan during the construction phase of the project. If the loan's fixed interest rate structure includes prepayment fees or penalties, there must be sufficient flexibility in the loan so that, loan prepayments arising from collection of special assessments due to the Association as units turn over, may be made to the bank without fee or penalty.

As part of the lending process, borrowers need to demonstrate a consistent standard of financial performance. These performance measures, known as covenants, are typically included in the loan agreement. These may include:

- ◆ Minimum reserve contribution levels and debt service coverage ratios
- ◆ Maintenance of adequate insurance coverage
- ◆ Annual submission of audited financial statements, along with periodic reporting of collections, litigation and foreclosure activity.

An Outline of the Criteria to Consider in Selecting a Lender

As with Legal, Accounting, Engineering and Management professionals, Associations should seek a lender who is experienced in working with Community Associations, and who understands the legal and fiduciary challenges faced by Board Members. Associations should strongly consider interviewing lenders, before requesting and considering competing proposals. Some of the criteria to consider during this preliminary interviewing process might include:

- ◆ The number and type of Association projects the lender has financed-especially in the State in which the Community is located (legal statutes vary by State)
- ◆ Knowledge of construction issues, along with the related experience of the lender's legal counsel and consulting engineer
- ◆ The loan officer's authority and stature within the institution and the approval process required to obtain financing
- ◆ Recommendations from the Association's Manager, Accountant and other satisfied Associations.

DO YOUR HOMEWORK BEFORE CALLING THE BANK!

Associations should be prepared to invest the necessary effort to ensure that they are entering into the most suitable financial arrangement to fund a Capital Replacement project. Funding scenarios should be modeled and evaluated as part of a joint review process conducted by the Association's Managing Agent, Board and Accountant. What follows is a list of essential items to be completed **prior to contacting a lender:**

- ◆ Project Outline/Description
 - Ancillary impacts (a siding replacement project could affect leaders, gutters, windows, etc.)
- ◆ Cost Estimates (often coordinated by the Management Company)
 - Construction
 - Professional Supervision
 - Overruns
 - Administrative
- ◆ Appropriate approvals by Association
 - Check with Association counsel to ensure all necessary legal processes are followed
- ◆ Financing Options Evaluation
 - Use of existing Capital Replacement funds
 - Special assessments
 - Loans
- ◆ Rate terms (fixed vs. floating)
- ◆ Repayment period/terms
- ◆ Impact Analysis on
 - Monthly assessments
 - Potential reserve depletion on other Capital Replacement projects during the loan repayment period
- ◆ Draft request for funding proposal to solicit competitive equivalent loan offers from funders
- ◆ Evaluation by Board, Managing Agent and Accountant.



All of these issues deserve exploration and consideration. Even the most competitive financing proposal is of little value if the loan officer cannot obtain approval to grant the loan or fails to adequately follow through on closing and funding the loan in timely fashion. Similarly, savings on up-front fees can quickly be eroded if the lender is using the Association's time (and money!) to learn the nuances of Community Association lending.

IN SUMMARY

Financing a Capital Replacement project can provide significant benefits to an Association and its members, but it is not without cost or considerable effort. It is also very situation- and, Association-specific. If a simpler and cheaper source of funding is available, such as, use of existing Capital Replacement fund monies, or through a modest assessment to unit owners, then any lender would recommend this as the preferred option. However, there are situations in which financing some of a project is the most appropriate and beneficial choice for an Association. If financing appears to be a positive alternative, the Association should first obtain the advice of its Attorney, Accountant and Manager before beginning the process of seeking an experienced lender. The Association should also be prepared to submit a complete package of financial information, project specifications and organizational documents to speed the process.

Should you have any questions, please feel free to contact me, or your Wilkin & Guttenplan advisor.

UPCOMING ISSUES:

- **Cash vs. Accrual Accounting**
- **2003 Budget Checklist**
- **Club "Do's and Don'ts"**
- **Checklist of Items in a Loan Documentation Package**
- **How Your Association's Investments are Insured**



NEWS AT THE FIRM

ANNIVERSARIES (July–September)

Congratulations to the following W&G staffers who celebrated the following years of service anniversaries:

- | | | | |
|----------|--------------------------|----------|--------------------------|
| 19 years | Edward Guttenplan | 14 years | Melissa Marsicano |
| | Edward Wilkin | | Debbie Norwicke |
| 16 years | Lori Barnhart | 12 years | Doreen Gordon |
| | Jeannette Everett | 9 years | Lauren Jablonski |
| | Jules C. Frankel | | Joanne Scott |

APPOINTMENTS, COMMITTEES, PRESENTATIONS, PUBLICATIONS...

Edward Guttenplan, CPA, MBA, has become a member of the NJ Society of CPA's Personal Financial Planning Committee. He has also been appointed to the Board of the Jewish Federation of Greater Middlesex County.

Marie Mirra, CPA, has been named CAI Conference Committee Co-Chair and will be the featured speaker on the topic "Cash vs. Accrual Accounting" for the CAI Conference scheduled for this September.

This publication is prepared quarterly by Wilkin & Guttenplan, P.C. For further information or for complimentary copies or subscriptions, you may contact Jules C. Frankel at:

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