



# Options for meeting financial obligations **in challenging times**

**Paul Morton**

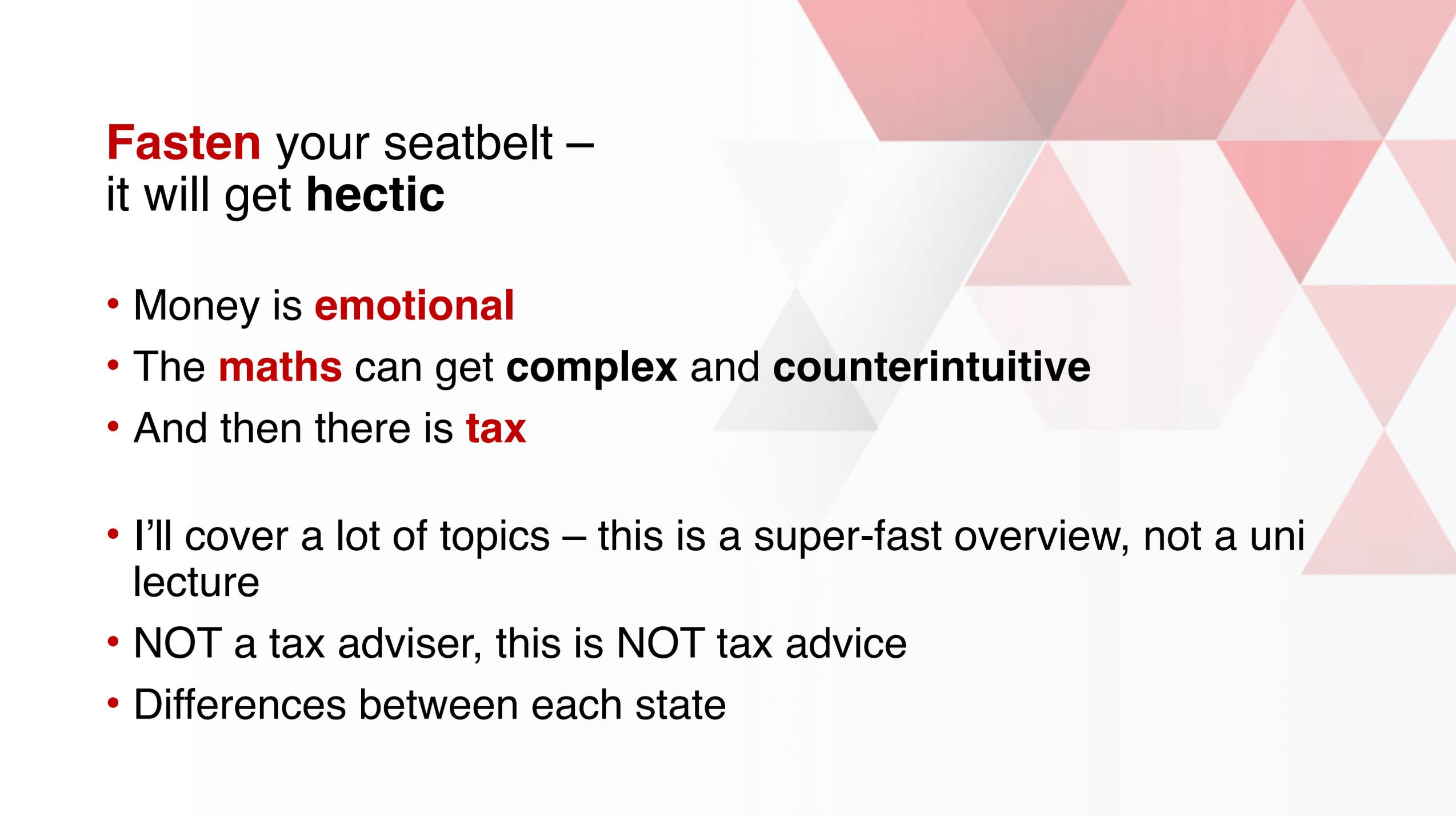
*Chief Executive Officer*  
Lannock Strata Finance



## A quick tour of the **next 60 minutes**

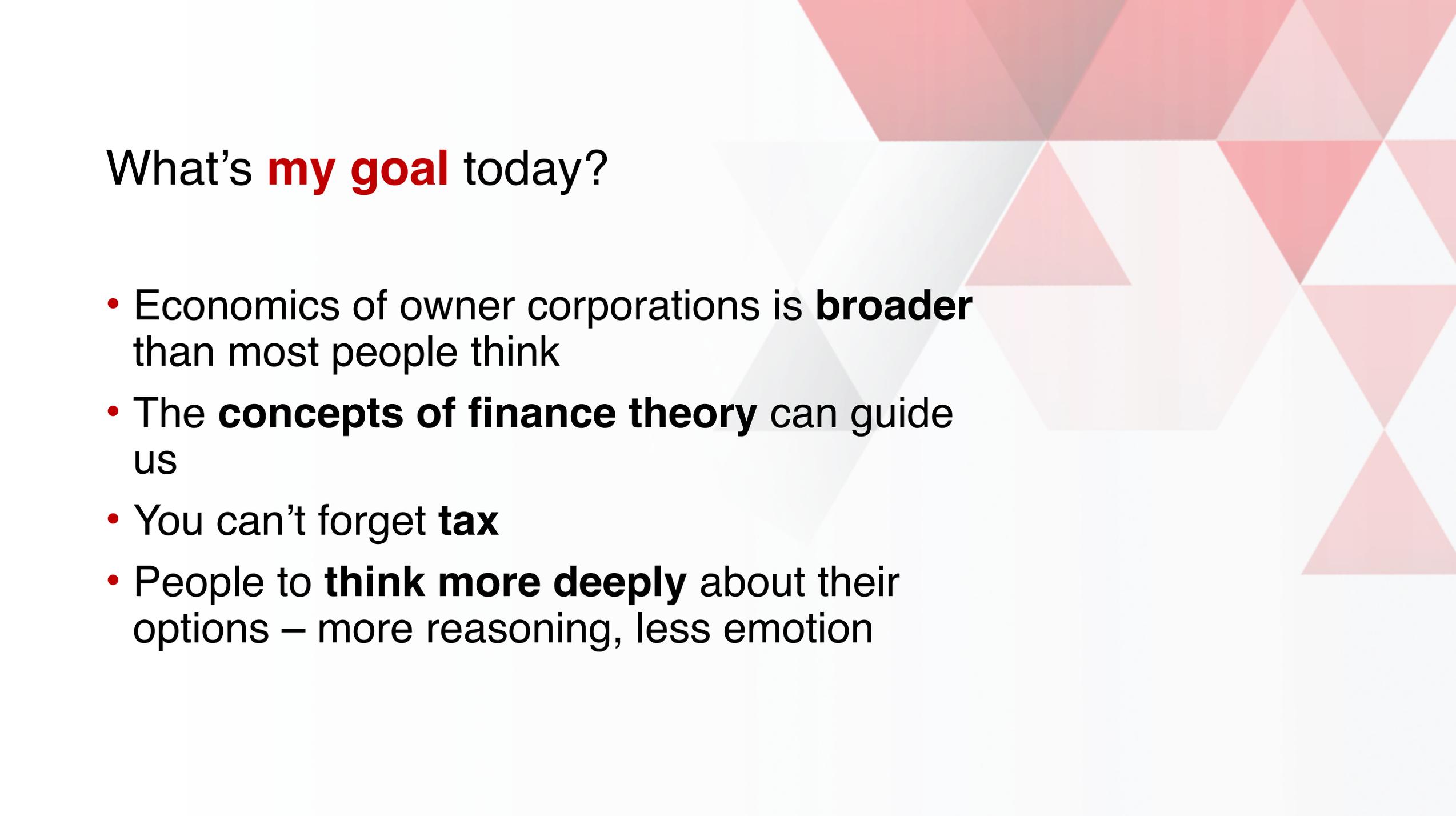
- What are these options?
- Attributes of these methods
- Tax
- Why borrow?
- Questions
- Renewal
- Summary





## **Fasten** your seatbelt – it will get **hectic**

- Money is **emotional**
- The **maths** can get **complex** and **counterintuitive**
- And then there is **tax**
  
- I'll cover a lot of topics – this is a super-fast overview, not a uni lecture
- NOT a tax adviser, this is NOT tax advice
- Differences between each state



What's **my goal** today?

- Economics of owner corporations is **broader** than most people think
- The **concepts of finance theory** can guide us
- You can't forget **tax**
- People to **think more deeply** about their options – more reasoning, less emotion

# Sources of Funds for an OC

- Traditionally, three sources:
  - Sinking/Maintenance Fund
  - Special Levy
  - Borrowing

Sometimes a fourth avenue...  
**other people's money:**

- Insurance
- Negotiation
- Litigation
- Government



# Attributes of funding sources

	Pros	Cons
Sinking Fund	<ul style="list-style-type: none"> <li>• “There when you need it”</li> </ul>	<ul style="list-style-type: none"> <li>• “It’s not there when you need it”</li> <li>• Expensive</li> </ul>
Special Levy	<ul style="list-style-type: none"> <li>• Efficient</li> </ul>	<ul style="list-style-type: none"> <li>• Onerous cash flow impost</li> </ul>
Borrowing	<ul style="list-style-type: none"> <li>• Cheapest for most owners</li> <li>• No waiting</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of understanding by owners</li> <li>• Australian love/hate relationship with debt</li> </ul>
Insurance	<ul style="list-style-type: none"> <li>• No (or limited) impact on current cash flows</li> </ul>	<ul style="list-style-type: none"> <li>• Limited to “insurable events”</li> <li>• Ongoing premiums</li> </ul>
OPM	<ul style="list-style-type: none"> <li>• Seemingly no cost</li> </ul>	<ul style="list-style-type: none"> <li>• Significant shoe-leather</li> </ul>
Litigation	<ul style="list-style-type: none"> <li>• No cost if you win</li> </ul>	<ul style="list-style-type: none"> <li>• Legal costs if you don’t win (yours and theirs)</li> <li>• Difficulty of tying down the appropriate counterparty</li> <li>• Insufficient when based on estimates, not actuals</li> <li>• Time</li> </ul>

Fallacy of a Sinking/Maintenance Fund as an **“equitable distribution of costs over time”**

# Why **borrow**?



Cheaper for majority of owners



Cheapest 'weighted average cost of funds'



Immediate



No 'dormant funds' accumulating over time in a sinking fund



No severe cashflow imposts

A quick overview...

## **Tax in Strata**

- Four relevant taxes
  - **Income tax** for the owner
  - **Income tax** for the corporation
  - **Capital Gains Tax**
  - **GST**



# A quick overview...

## **Tax in Strata**

- Four types of owners
  - Residential owner occupier
  - Personal investor
  - Company investor
  - Super fund investor



A quick overview...

## Tax in Strata

- How many types of levies?
  - Sinking Fund Levies
  - Special Levies
  - Administration Fund Levies
- 1 – Levies to the sinking fund
- 2 – Levies to the administration fund



A quick overview...

## Tax in Strata

- Each of the two types of **levies** play out **completely differently** for each of the **four taxes** for each of the **four types of owners**



A quick overview...

## **Tax in Strata**

- Q: Who knows this?
- A: Far too few people
  
- Unfortunately, you can't just go to your adviser because they probably have never thought about this



# Concepts from **Finance Theory**

- Opportunity Cost – the next best thing you could do with your money
- ROI – Return on Investment
- Capital Budgeting



# Opportunity Cost

- “No free lunch”
- The money you pay in levies is not free
  - Do you have credit card debt?
  - Would you have credit card debt?
  - What about that new car?
  - Or giving it to the kids?
- Whatever is the next best thing that you could do with your cash is your **Opportunity Cost**



# Return on Investment

- What's the **bang** for your buck?
- What **value** do we get in return?
- Financial return + how do you feel?
- Owner occupiers **vs** investors



# Applying finance theory to **strata**

- Get out of the scarcity trap – think **ABUNDANCE**
- **Think** investing, not expensing
  - Invest means **ROI**
  - Expense means **cheap**
- Not the cheapest **quote**
- Not the cheapest **project**



# What's bad about **Sinking Funds?**

- People don't think
- Not account for **opportunity cost** – is the money better in your pocket or the OC's pocket?
- Financially inefficient – typically the most expensive form of funding
- Low returns
- Not free money



# Special Levies are **not** the **devil**

- Cost effective
- Cause for people to **think**
  
- Concerns
  - Cash flow **impost**
  - Opportunity cost
  - Like a Sinking Fund, is **not free money**
  - What if some people can't pay? – impacts timing



## More about **Strata Loans**

- Gets you out of scarcity mode
- Spreads cash flows over time
- Cheaper, **after tax**, for the **majority** of owners!
- Quick
- **Off** balance sheet – doesn't affect your available funds or lines of credit
- Not free money



## If strata loans are **so good**, **why don't people use them more?**

- Lack of **financial understanding** – owners, managers and legislators
- Strata **naysayers** subvert the decision processes – natural desire for **consensus**
- Australians **say** they don't like debt
- The **FUD** factor
- Inappropriate **legislation**



## Questions – Will **Why aren't strata loans cheaper?**

- Unsecured
- Bank capital weighting
  - BASLE III, APRA
  - The higher the capital weighting, the more expensive
- Size of market and economies of scale – the mortgage market in Australia is **20,000** times bigger than the strata loan market



# Questions – Susan

## Hybrid loans

- Trying to solve this for a long time
- Two broad types of “solutions”
  - Special Levies
  - Some owners lend to the corporation
- Evaluation **metrics**
  - Complexity
  - Fairness
  - Compliance
  - Understanding
  - Hidden consequences



# Questions – Susan

## Hybrid loans – Special Levies

- Raise a special levy
  - Apply the discount on early payment and or the interest rate on arrears
  - People who can or want to pay do
  - Corporation borrows the amount unpaid
- Consequences
  - Disenfranchises the non-payers
  - Unknowable time frame for non-payers
  - Very difficult to get the maths right



## Questions

### **Hybrid loans – Owner Lending**

- Cannot offset (i.e., “net”) the interest earned by the lending owner against the levies they must pay
- Interest earned by the “lending owners” is taxable at their marginal rate
- Administrative burden



## Questions

### **Hybrid loans – issues for managers and OCs**

- If you are a strata manager – can you (and your auditor) reconcile “netting” with their obligations under the Property , Stock and Stations Act?
  - NSW OFT – must go through the bank accounts, not internal ledgers
- What is the administrative burden and what will that cost?



## Questions

### **Hybrid loans** – if you are an owner

- What is your real cost of funds?
- What is it after tax?
- What is it in comparison with the after tax cost to you of a strata loan?
- At what rate will the interest you receive on your loan be taxed?



# Questions – Susan

## **Selling my unit**

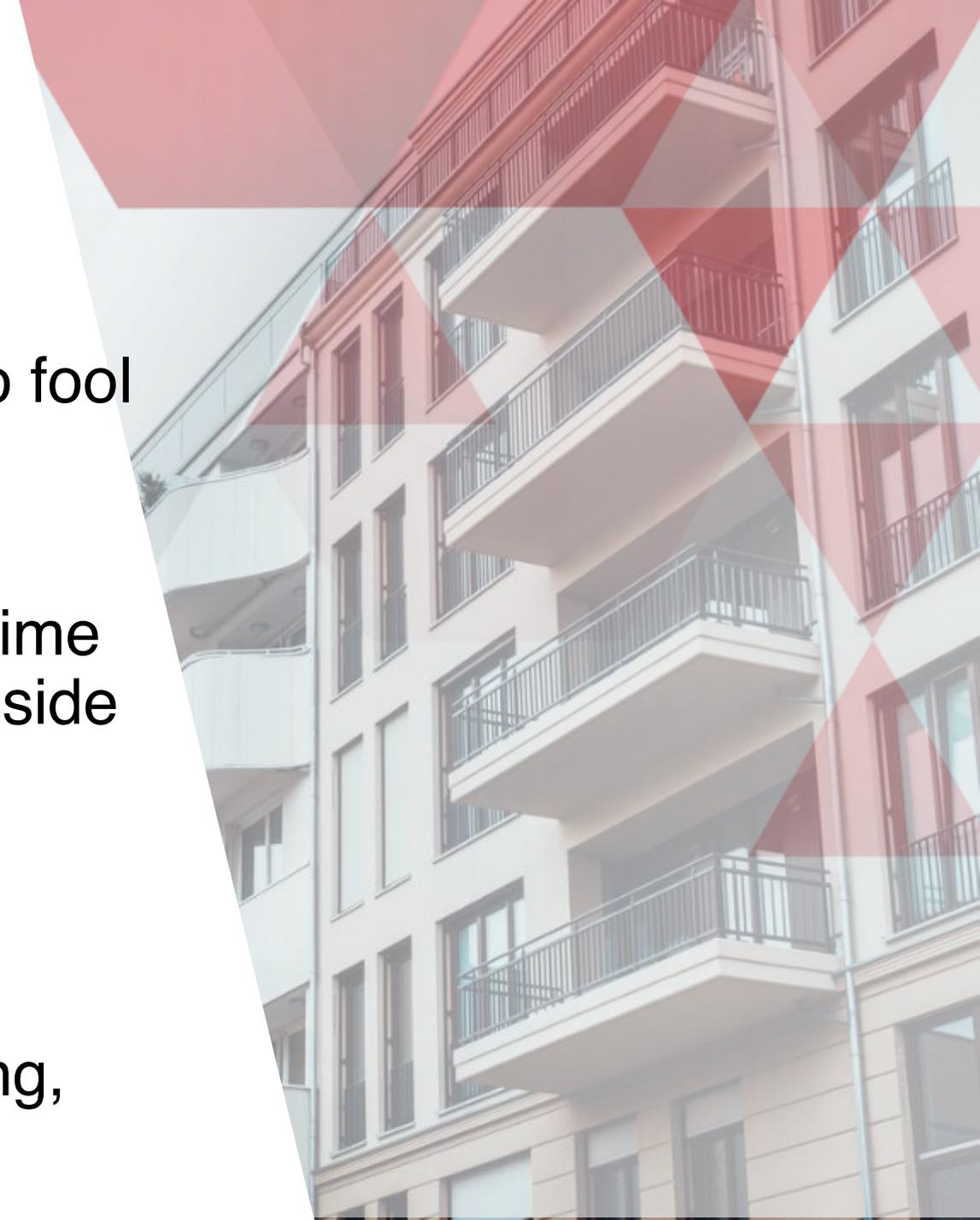
- If there's a strata loan, a purchaser won't pay as much because the levies are higher

<b>Strata Loan</b>		<b>Special Levy</b>	
Owner perception of value	\$100	Sale Price	\$100
Notional share of strata loan	\$10	Required investment to get that value	\$10
Sale Price	\$90	Net return to seller	\$90

## Questions

### **Selling my unit – what's really going on?**

- We should **think broadly** – we like to fool ourselves about values
- Think in terms of return, i.e., **ROI**
- In strata, owners always pay, all the time – **compare** – there's always another side to the funding coin
  - Cost of finance
  - Opportunity cost
  - Capital value
- It's right to focus on the cost of funding, but shhhhh, there's a secret.....



# Questions

## A little strata secret

- Of course I want people to **think deeply** about the economics of strata funding, but.....
- The costs of each funding alternative are **not too disparate**
- Where is the **big** impact on ROI?
  - The **project** you choose
  - The **contractor** you choose



# Questions – David and Malcolm

## **Water Leakage and Deck**

- 51% majority required in NSW
- If no satisfaction from the OC, consider NCAT
- Considerations for the 49% against a loan:
  - What is your cost of funds (opportunity cost)
  - What is it **AFTER TAX**?
  - Impact on rental return
  - Impact on capital value



# Questions – David

## **Another little strata secret**

- **NEVER** stage a project
- Why do we try to stage projects?
  - Scarcity thinking – we don't have the cash
- Why we should **never** stage projects
  - Inflation – CPI, LMI
  - Duplicate costs
  - Duplicate effort
  - Inconvenience of living in a construction zone
  - You just get **TIRED**



## Strata **Renewal**

- "We have [**insert problem here**] but if we do [**insert good idea here**] and put a penthouse on the top then we fix all the problems, add new features and selling the penthouse will pay for everything"

# Strata **Renewal**

- Glenview Towers – before
  - Two **fire** orders
  - Concrete **cancer**
  - 78 lots with 180 degree ocean views and **no balconies**
  - Only 50 car spots, all open air
  - An **ugly** blot on the landscape
- **Skye** Tamarama – now
  - **2 lifts** instead of one
  - **78 balconies** with floor to ceiling glass doors
  - Underground parking for **90 cars** with lift access
  - 2 penthouses now **on the market**
  - A **pleasing** blot on the landscape

# Strata **Renewal**



# Strata **Renewal**



# Summary

- Broader and deeper thinking
- All three options have merit
- Opportunity Cost
- ROI
- Get rid of scarcity thinking and costs
- Think in terms of investment and returns
- **TAX!** Educate your trusted adviser



## The real takeaway

- **Abandon** your scarcity mindset
- Think about **returns**
- Let loose your **imagination**

