Warning – Assessment Increase Tsunami Coming

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As an old WAOTH (Wise *ss on the Hill), I was asked to author an article about how inflation might affect homeowner association regular assessments. With some degree of confidence and without arrogance, I countered with – there is a perfect storm of events going on out there and the coming Common Interest Development (CID) regular assessment increases and special assessment levies will be at flood levels.

Here, in no order, are the top ten variables in play:

1. Inflation
2. Debt terms and conditions
3. Owner expectations
4. Aging facilities
5. Process improvement limits
6. Talent shortage
7. Leadership skill set
8. Legislative cost mandates
9. The CID governance structure
10. Vastly underfunded, underestimated, and under disclosed Major Repair & Replacement (MRR) obligations

A deep dive into each variable could be a chapter in an excessively big book. Speculating on the percent or dollar impact of the combined effect of these variables in general or on any individual community would be without merit. On the other hand, your common sense can envision a large, combined effect in any given situation.

I will briefly comment on these variables. The desired outcome is that you let the information sink in, and you start preparing your leadership team and stakeholders for the coming regular assessment increases and special assessment levies.

What should be done? Community leaders, their professional advisors, and leadership team should designate someone as the Chief Strategy Officer and empower that person to:

1. Evaluate how each of the ten (10) variables noted above applies to the community.
2. Use that information to build long-term financial "what if" models that create clarity about the range and domain of possible and probable combined financial and political effect on the community.
3. Prepare community stakeholders for the coming fee increases with explanatory townhalls and over communicated messaging to give them time to go thru the loss process – denial, anger, blame, negotiation, acceptance.

Ironically, the very act of preparing for this assessment increase tsunami has its financial and political impact and will be disruptive. Deniers will push back on the effort. Bold leadership and tough skins will be required. Time for the trade associations, managers, vendors, community leaders, and commentators to ring the bell. It is a Paul Revere moment.

What will be done? My cynical self suggests not much. The tradition and practice in the CID world is reactive and transactional. Not strategic. Financial literacy levels are low, and strategic thinking, planning, and influencing is not in the DNA nor the funding model. Yet, a sense of urgency about and preparation for the tsunami is the lowest cost option.

With that preamble, let us jump down this rabbit hole.

Combined effect. The truth is that the overall effect of these tectonic plates shifting is situational. While every CID community will be affected by these variables, the result will be uneven depending on how each variable applies to each community's situation. Large scale communities with robust common area facilities to maintain, services to deliver, and past underfunding issues will see the biggest impact. Communities with de minimis common areas to maintain, not so much. In plain language for some communities the cost to cure will be nominal. For others it will be financially and politically disruptive.

1. Inflation. At its core, the primary cost driver for CIDs is compensation for services rendered. As we will see later, the opportunity for cost reduction due to productivity gains is extremely limited. Overall inflation rate was 8.5% in March of 2022 *(U.S. Bureau of Labor Statistics (BLS))*. Compensation inflation for 2022 is expected to be at least 3.5% *(BLS)* which when combined with minimum wage increases, signing bonuses, and performance bonuses could be more like 10% in the CID world.

2. Debt terms and conditions. A combination of failure to increase assessments timely and appropriately plus unanticipated major repair and replacement cost increases (think oil-based products) has led CIDs to use long term debt secured by special assessments to cure these issues. The cost to rent money is on the rise. A year ago, typical bank seven-year money rented (interest) for around 4%. Today that rate will be more like 5% to 6% and could go higher as the Federal Reserve Bank attempts to curb inflation. A 25% to 50% increase in the cost to rent money.

3. Owner expectations. Our United States culture suffers from "I want it better, faster, cheaper" disorders. Disorders that include: "I want the best talent available 24/7." "I want it perfect-now." "I want to talk to a real person." "We want the upgraded replacement." All of which requires service providers and product supply vendors to relentlessly, continually, and competently, overstaff, and engage clients face to face. Moreover, conflict resolution events are on the rise as tension mounts over funding, compliance, and behavior issues. The time talent and treasury required to resolve these conflicts will not be trivial.

4. Aging facilities. As discussed later, common area facilities are aging. While early intervention is almost always the lowest cost option, communities tend to delay these expenditures - which can have significant cascading consequences. Except in rare circumstances, as technology, expectations, and standards evolve, the cost to maintain increases. For landscape intensive communities, climate change and drought will require massive investments in landscape renovation.

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5. Process improvement limits. One variable that keeps inflation at bay is labor productivity improvements. Yes, in the last 20 years, technology and other process improvement initiatives have contained cost increases in CIDs. The trend to offshoring back-office work to Mexico, Philippines, etc. by management companies grows mostly without client awareness. On the other hand, onsite maintenance and a complimentary team of managers, advisors, and other subject matter experts cannot be automated, or outsourced to low-cost countries. In plain language and to borrow a notion from physics – there are productivity improvement limits especially in a labor dominated function. There are no productivity improvements to performing a live opera. It takes the same instruments, the same time, and same high-end talent. Okay, robots could replace the music and talent, but it would not be the same experience.

6. Talent shortage and expectations. Several harsh realities exist in this variable. At the national level, the unemployment rate at this writing is in the 3.5% to 4.0% range *(BLS, March 2022)*. A better than "full employment" range. Furthermore, there are about 11,000,000 job openings *(Trading Economics, February 2022)*. Those jobs are unfulfilled for four primary reasons – absence of skill sets, location disruption (I do not want to move to where the jobs are), insufficient compensation, and a shrinking work force *(10,000 baby boomers turning sixty-five everyday U.S. Census Bureau)*. Population growth in the U.S. over the last five years has averaged less than six tenths of one percent and is projected to decline steadily to the end of this century *(U.S. Census Bureau)*. In the first ten post WW II boom years, it was more like 1.5%. In the CID world the number of communities continue to grow. Yet, senior industry institutional knowledge is aging out of the system and the incoming talent pipeline is sparse, with different ambition levels, a different work ethic, and a different view of work's role in their life. Therefore, the industry suffers not only normal compensation inflation, but also suffers a leadership talent and competence shortage which, of course, drives up the "poaching" cost (the cost of one vendor to acquire talent from another vendor) as well as the recruiting, training and retention dance. A classic supply demand imbalance situation.

7. Leadership skill set. Subject Matter Expertise (SME) by CID community leaders, managers, advisors, and vendors is permission to play smart skills. Building trust among strangers and the ability to create clarity about what success looks like and how to obtain it are essential organizational health skills. The former is a work in progress and the latter is only now emerging as a legitimate quest. Both are hindered by the 6 T's – talent, turnover, technology, training, tradition, treasury. All increased cost drivers.

8. Legislative cost mandates. In general, CIDs are inherently unable or unwilling to perform their duties to identify, fund, and disclose their periodic (non-annual) Major Repair & Replacement (MRR) obligations, the California consumer protection mind set will raise its head and the legislature will impose statutorily mandated maintenance obligations and related funding requirements. And, if history repeats, those mandates will be classic costly pounding tacks with sledgehammers. Moreover, there will be a push for some type of regulatory and enforcement agency. A consumer protection governmental agency that will be funded by a per unit "tax" as is done in Florida and Nevada. The Highway Patrol for CIDs.

9. The CID governance structure. The CID self-governing model is fundamentally flawed. The board of director's have a conflict of interest. On the one hand they have a fiduciary and legal duty to levy assessments sufficient to maintain the common area at an ascertainable standard. On the other they are raising assessments on themselves. That fact coupled with owners who elect the board and resist assessment increases produces minimum current maintenance levels and large deferred unfunded maintenance liabilities which lead to large special assessments. Large special assessments that may require the CID to function as a bank and finance the repairs with a long-term bank loan secured by the special assessment. And, oh yes, the bank loan itself may require

owner approval which drives up the cost to cure if the CID must go to court to gain approval for the loan. You do not need to be a finance scientist to assess the cost impact of this mess.

10. <u>Vastly underfunded, underestimated, and under disclosed Major Repair & Replacement (MRR) obligations</u>. The central finance question in the CID world – **who pays for what when and why?** The recent Champlain Towers collapse in Florida has triggered new focus on this issue. It cannot be overstated that the most challenging CID financial issue is the recognition, funding, and disclosure of each community's Major Repair & Replacement obligations. Without question this variable will become the most financially disruptive of the ten. It will manifest itself in several ways:

    a. Large, stop the bleeding "Catch up" special assessments the payment of which will be deferred much like a reverse mortgage.

    b. Higher than "normal" annual increases in regular assessments designated for MRR on future owners to cure past underfunding assessment patterns by past owners.

    c. Other regular assessment increases and special assessments to manage underestimated inflation and costs at the component level.

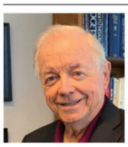
    d. New legally mandated inspections, standards of care, and funding levels.

    e. A "kitchen sink" addition of Major Components in replacement studies that will drive up the famous percent funded denominator and create drama and debate over, you guessed it, **who pays for what when and why?**

So, there you have it. The assessment increase tsunami is coming. You have been given a fair warning. You choose your path forward.

"The central finance question in the CID world is – who pays for what when and why?"

"The assessment increase tsunami is coming."



Mr. Haney is the principal shareholder in Haney Accountants, Inc., a California CPA licensed corporation and the Managing Member of the CID Consortium, LLC, a CID Community Management Company. His firms have been providing virtual controllership, management, and leadership coaching services to CIDs for over 45 years. He can be reached at 888.786.6000 x325 or dw@haneyinc.com. Email him your questions and he will get to as many as he can. If you have ideas about future commentary on this subject or others, contact him.