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*“The greatest growth industry around ...”*

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National Community Titles  
Institute – Congress 2006

**The Winds of Change –  
Are you ready?**



*By*

***Gary F Bugden***



# About the Author ....

Gary Bugden has been involved in the strata title industry for over 30 years. Between 1970 and 1973 he was engaged in a broad based property law practice, including strata titles. In 1973, in conjunction with his mother, Nita Bugden, he started Australia's first dedicated strata management business, Residential Unit Management Pty Ltd.

Together they computerized the record keeping of that business, built it up and sold it to start their next venture, a records inspection company. The family still holds the major shareholding in that company, Purchasers Strata Inspections Pty Ltd, the Board of which is chaired by Gary.

Those ventures were followed by other business investments in the industry, namely Body Corporate Services Pty Ltd, ComStrata and most recently INSiTE.

While involved in all these activities Gary carried on a very busy legal practice, for most of the time as a partner in the National law firm, Mallesons Stephen Jaques, specializing in strata and community titles at the most complex levels. During his time with Mallesons Gary held senior management roles and also served on its National Board for 10 years. He completed executive training courses with INSEAD (France) and the Australian Graduate school of Management. He also lectured part time in strata titles at a Sydney Law School and authored 4 books and 3 loose-leaf services on strata and community titles, all published by CCH Australia Limited.

In 2001 he retired from general legal practice and has since focused on a number of property related directorships, including a director of the Hawaiian Management Group out of Perth, the Chairman of the Ray Group on Queensland's Gold Coast and Chairman of the Multiplex-Consolidated Properties joint venture, Domain Resorts. He is also deputy Chancellor of Bond University and President of the College of Community Association Lawyers Inc..

Gary is known for his strategic and management skills, particularly in the strata titles area. As evidence, he is credited as the pioneer of airspace subdivisions and master planned community developments in Australia.

# The Winds of Change – Are you ready?

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# The Winds of Change - Are you ready?

*“Nothing endures but change.”*

Heraclitus (540BC – 480 BC)

## Introduction

For over 30 years I have had the benefit of seeing the strata management sector emerge, grow and change. I have been fortunate to view this process from a number of different angles – through the eyes of a lawyer, a law firm manager, a strata manager, a records inspector, a property developer, a property investor, a “researcher” of overseas projects, a unit owner, a legal author and an academic and law reformer.

Today I will give you my perspective of the strata management sector, as well as my views on where it is heading and what you as sector professionals might do to prepare yourselves for the changes that appear to me to be inevitable.

## Approach

I don’t propose to go into a lot of detail justifying the views I have formed on the strata management sector. Those views may be controversial to some of you, but I suspect they will be substantially accepted by most of you.

Instead, I will focus on what the options are for strata management professionals and what I think is needed for you to successfully pursue those options.

## Outcomes

The outcomes that I am looking for at the conclusion of this paper is for you, the audience, to be provoked into thinking about your future in the sector and the need to decide how you will respond to the challenges ahead. In addition, I hope that you will take away some useful ideas that will guide you in your future planning.

*... be provoked into thinking about your future in the sector and the need to decide how you will respond to the challenges ahead.*

## Where have we come from?

### The scene in 1973

When the policy for second generation New South Wales legislation (the *Strata Titles Act 1973*) was being developed strata management was the reserve of accountants and real estate agents who effectively treated it as a “side line” to their core businesses. While there were a few large strata management businesses within accounting and real estate firms and at least one real estate agent focused on strata management in preference to general real estate, there

was no dedicated specialist strata management firm until Residential Unit Management Pty Ltd entered the market in 1973.

Strata management was essentially a secretarial role and well suited to accountants. The real estate agents, because of their experience in general property management, added an additional perspective – property maintenance. Record keeping was a manual task. The fancy systems of the day were punch card machines and the Kalamazoo accounting system.

Residential Unit Management was the leader in the use of technology – it used a data processing centre operating a modified accounting system run on a main frame computer. Each day data sheets were prepared and delivered to the data processing centre where they were entered and returned the next morning for “corrections”. Reports were ordered days in advance of when they were required. Accountants used separate bank accounts for each body corporate and real estate agents used combined trust accounts. The processes were relatively inefficient and the scene was far from professional.

The impetus for specialist strata management firms was the introduction of the office of “strata managing agent” in the 1973 New South Wales legislation and the structuring of that office as a “delegate” of the body corporate. For the first time there was a legally recognized “position” that could be occupied by those engaged in strata management – an important position that, in many ways, made the management of bodies corporate easier.

*There was no sign of a professional strata management sector prior to 1973, although the introduction of the concept of a “strata managing agent” in the second generation New South Wales legislation opened the door to development of the sector.*

### **The next 10 years (1974 – 1984)**

The next 10 years saw a noticeable increase in the number of firms offering strata management services. There was also a move on the part of some accounting and real estate firms to “convert” to specialist strata management firms. Indeed, this decade was the period of growth of specialist strata management firms.

Other developments of significance were –

- The development of the first purpose built computerized accounting system for strata management (by Olivetti Australia Limited, with assistance from me).
- The emergence of specialized management firms in Queensland following the second generation legislation in that State in 1980 and the commencement of Body Corporate Services in that same year.
- The establishment of the Institute of Strata Title Management (“ISTM”) in New South Wales.

However, the standards of strata management did not progress significantly during this period. Fees were low and returns were modest. The ISTM was developing, but had not started to make a noticeable impact on the professionalism of the industry. Virtually the entire industry was comprised of “family businesses”. This was the birth of the “Mum and Dad” era of strata management.

*The 10 years to 1984 saw the emergence of a specialized strata management sector that was positioned to grow and develop, along with the supply and variety of strata title properties.*

### **The second 10 years (1985 – 1995)**

This was a period of rapid growth in the development of strata title properties. The number of schemes and lots exploded right across the country and significant numbers of new strata management businesses arose as a result of and in response to that growth.

The main features of this period were –

- The introduction of personal computers in many strata management offices and significant progress towards improving accounting practices with the introduction of industry specific computerized accounting programs.
- The first listed strata management company (albeit a back door type listing).
- The ISTM had grown and prospered and was starting to have a real impact on the standards and professionalism of strata management.
- Other industry bodies were established in Queensland, Victoria, Western Australia and South Australia and a national body was on the drawing board but bogged down with inter-state differences of opinion.

While this period saw improvements in management practices and professionalism, the profile of management companies remained substantially unchanged. The sector continued to develop, but very much in the Mum and Dad type mould. Low profitability of management companies remained a problem and the expectations of strata management customers (i.e. the bodies corporate and their office bearers) remained relatively immature.

*While in the 10 years to 1995 there were improvements in management practices and professionalism of the strata management sector, the cottage industry profile of the businesses did not change.*

### **The last 10 years (1996 – 2006)**

I would describe this period as the “*Golden years of professional strata management*”. During this period the sector progressed significantly. A number of encouraging things emerged –

- The National Community Titles Institute was finally established and managed to grow and prosper.
- Professional management systems were improved, strata management practices became more professional and managers became more knowledgeable under the increasing influence of the State industry bodies, such as the ISTM.
- The sector began attracting tertiary qualified people who are starting to have an impact on the quality of management at both levels – the business and the portfolio management levels.

However, this period has also had its challenges. The legislative environment in which bodies corporate operate became more complex and demanding for strata managers. Consumer

protection mechanisms introduced by some States added to these difficulties. Strata title developments became larger and more complex in the way they were structured, adding further complexity to the management of some bodies corporate. Leasehold strata title and community title developments became more common and made further demands on the knowledge and skill levels of strata managers.

Despite all this, and despite some notable exceptions, the profile of the industry remained substantially unchanged. While it is more efficient and professional it is still heavily based on the small Mum and Dad operation. Even the larger firms don't operate much differently today than they did say 10 years ago. The extent of change within the sector has not kept pace with the extent of change in the wider business community.

Perhaps the most significant development within this period was the identification of the sector by "big business" (particularly venture capitalists) as being a fertile area for consolidation.

*The last 10 years heralded significant progress in the professional strata management sector, although the pace and extent of change was relatively slow when compared to other parts of the professional services sector.*

## Where are we now?

To form a view on the current state of the strata management sector one needs something from which to benchmark. To my mind the logical sector to use as a benchmark is the professional services sector. After all, what the strata management sector is all about, or what it aspires to be all about, is the provision of professional management services to bodies corporate. To further narrow the comparison, I looked at legal and accounting firms and used them as my benchmark. To balance the scales I tried to make some allowance for the exceptionally long period of time that the legal and accounting professions have taken to develop compared to the strata management sector which, after all, is a mere 45 years old. I also tried to make allowance for the different fee structures of those sectors.

*To my mind the logical sector to use as a benchmark for assessing the strata management sector is the professional services sector – in particular the legal and accounting firms.*

What I concluded can be summarized by saying most strata management firms display some or all of the following qualities –

- Are not very efficient in the way they perform, either at a business or portfolio management level
- Have little or no focus on strategic planning
- Are not sufficiently customer focused and offer inferior levels of service to their customers
- Have only basic technology and no real strategy or capacity to improve their technology
- Have low skill levels with few or no appropriately qualified people in key roles

- Are not very sophisticated when it comes to marketing
- Are not focused on skills development through training and career development
- Low profitability.

In a nutshell, when compared with legal and accounting firms (even after allowing for fee differences and longevity), most strata management firms are still very much in the cottage industry or small family business mould where the principal(s) work *in the business* rather than *on the business*.

Most, if not all, strata management businesses are not scalable and have little capacity to increase their margins. To some degree these views are supported by the 2005 Macquarie Bank sector survey.

While good progress may have been made in the past 10 years or so, the sector still has a long way to go and it is not entirely clear how it will achieve the quantum leap that is needed for it to catch up with other professional services firms.

*When compared with legal and accounting firms most strata management firms are under resourced from a technology, process and business skills perspective and are still very much in the cottage industry or small family business mould.*

## The most likely scenario

In my view the most likely scenario is that the strata management sector is heading into an era of consolidation. By that I mean that well capitalized companies (whether existing or purpose built) will develop the sophisticated technology, resources and processes needed to successfully acquire and integrate a large number of strata management portfolios. The “drivers” of this consolidation will be –

- Consolidation trends in the service industry sector generally
- The current business profile of the strata management sector
- The age and objectives of a significant proportion of principals of strata management firms (i.e. to sell their businesses and retire)
- The bad debt free, regular and automatic cash flow attraction of strata management businesses
- The amount of money handled by the sector (e.g. levies, sinking funds, repairs and maintenance, etc.)
- The underperforming nature of the sector
- The opportunity to vertically integrate the supply of services to bodies corporate, owners and occupiers
- The rapid future growth of the sector.

*The strata management sector is rife for consolidation and the “drivers” for this type of change are clear and indisputable.*

To achieve their objectives, these companies will –

- Manage their own business in a very strategic and professional way
- Automate the accounting, record keeping, meeting and building maintenance functions of strata management (i.e. introduce state of the art technology)
- Offer a more people focused management service centered around the key asset – the strata building
- Vertically integrate much of the goods and services supply chain to bodies corporate, unit owners and occupiers
- Increase revenues per lot from the current \$240 per lot (average for larger firms) to around \$500 per lot and above
- Raise profit margins (EBITDA) to around 40% of revenue

This will emulate what is already happening in the management rights and property management sectors, as well as numerous other service industry sectors.

*The players in this new world of consolidation will need to be strategic and professional and well resourced to succeed, particularly in the areas of capitalization, management expertise and technology.*

However, this will not be an easy process. Companies have tried this in the immediate past. Some have never managed to get a start and the one or two that did manage to get a start did not succeed, or at least until now have not succeeded. The following are the challenges that these entrepreneurial companies will face –

- Raising on acceptable terms the large amount of capital required
- Finding business professionals experienced in managing rapid growth strata management businesses (rapid growth being necessary to provide a timely and sufficient return on the invested capital)
- Keeping the venture capitalists sufficiently out of the business to ensure that management has the right focus
- Funding the technology and management process infrastructure required to ensure that the company is scalable and capable of coping with rapid growth
- Finding sufficient high quality strata management businesses to acquire
- Managing the integration of the businesses acquired during a rapid expansion program
- Finding sufficient qualified and experienced portfolio managers (i.e. strata managers)

- Increasing revenues per lot without destabilizing the client base, many of whom will be relatively new to the business
- Successfully charting and achieving an exit strategy (being either an IPO or a trade sale).

Despite these challenges, I believe consolidation will happen. Even if individual companies are unsuccessful at first, they, or others, will find ways to succeed. Do not be led into a false sense of security by what has happened to date; others will learn from the mistakes of the past and future attempts are likely to be more sophisticated. It is only a matter of “when” not “if” consolidation will occur!

*The process of consolidation will not be easy. There are significant challenges, but at the end of the day there is a high degree of inevitability about consolidation of the strata management sector.*

## Responding to sector consolidation

To my mind strata managers can respond to sector consolidation in any one of 4 ways –

1. Become an entrepreneur and play in the main game (i.e. restructure your company, raise capital and go on the acquisitions trail).
2. Restructure your business into a boutique operation with a focus on customer service in a designated market (i.e. “future-proof” it).
3. Aim to be a “seller” by preparing your business for sale.
4. Do nothing and just carry on as normal.

*Strata managers have a number of options to choose from. The trick will be choosing the right one.*

If you choose the first one, then hopefully you will find my earlier comments useful. Remember, you don’t have to become the main player in the main game – you only need to make yourself attractive to the main player. You might call it “the mating game”. However, I suspect that only a few of you will seriously contemplate the first option.

If you choose the second option you should be able to comfortably survive in this competitive new world as it eventuates. This is because you will be highly organized and firmly focused on a profitable market sector (e.g. large, high-end complex projects). Your services will be in demand because of your specialist skills and those in need of your skills will seek you out as an individual rather than as a company. You will be chosen in preference to the larger “branded” firms.

If you choose the third option, then you may find useful my following suggestions about how to prepare your business for sale. Judging by the Macquarie Bank 2005 sector survey (which indicated that 40% of principals planned to sell equity in their businesses in the next 4 years) I suspect that a number of strata managers will be keen to pursue this option.

If you choose the fourth option, then you don’t need help from anyone. But, be careful, in a few years time you may find your business retracting and your asset slowly disappearing.

## Preparing your business for sale

Two things are certain for the future –

- Companies will be very fussy about the quality of the portfolios they acquire
- The price paid for portfolios will be dependant on the quality of the portfolios.

When I talk about the quality of the portfolio, I am referring to a number of things –

- The size and nature of the buildings in the portfolio
- The total revenue generated per lot per annum
- The length of the management agreement
- The state of the body corporate records
- The customer satisfaction levels.

*Building a quality portfolio is an important starting point. But quality goes far beyond the size and type of buildings that make up the portfolio.*

This leads to a fairly logical list of things strata managers can do to prepare their businesses for sale, namely –

1. Be strategic in your marketing to ensure that you build a portfolio of premium buildings. Geographic spread is less important than quality, provided the profile of lot owners is such that they can afford to pay more for better and more extensive services.
2. Don't build the revenues per lot to the extent that there is no scope for the buyer to increase those revenues. One of the objectives of the buyer will be to increase the revenues per lot, so always leave something there for the buyer.
3. Always insist on 3 year management agreements and tighten up the termination provisions (within reason).
4. Include a provision in your management agreements for assignment (in jurisdictions where this is permitted) or a conditional contractual commitment on the part of the body corporate to facilitate the appointment and delegation of an "assignee" of the agreement.
5. Ensure that the records and affairs of individual bodies corporate are complete and in good order, in particular:
  - (a) ensure each body corporate has a complete set of records required to be kept by the relevant legislation and ensure they are up to date;
  - (b) have evidence of currency of insurances and copies of policies available;

- (c) ensure income tax and other revenue laws are being complied with;
  - (d) have certificates of title for common property available in jurisdictions where they are issued;
  - (e) regularly reconcile bank accounts and have the latest statements available; and
  - (f) ensure annual meetings are up to date;
6. Establish and maintain your own business records that monitor the critical risk areas in your body corporate management activities, such as registers of:
- (a) insurance due dates;
  - (b) annual meeting (and associated) dates;
  - (c) quarterly levy dates;
  - (d) fire safety inspections and certifications; and
  - (e) workplace health and safety audits.
7. Develop good relations with your customers so that there will be clear evidence for a buyer that they are more likely on a sale of the portfolio to transfer their management than seek alternate third part management.

Item 3 is very important because it will influence the valuation of the portfolio for the purpose of the new international accounting standards. The chances are that a company participating in the consolidation of the sector will need to prepare their accounts to those standards. Items 5 and 6 will be critical to the due diligence process that will become the norm for acquisitions. Good records of critical matters will significantly enhance the prospect of a sale and may even result in a better price.

*Assuming that companies engaged in the consolidation process will be keen to learn from the past, they will be careful to undertake a thorough due diligence process and the price they are prepared to pay is likely to be based on the outcomes of that process.*

The next thing that I would like to speak about is the value of strata management businesses. Traditionally they have been valued on the basis of contracted revenue per annum. The “norm” is said to be around \$1.60 per \$1.00 of contracted revenue per annum, although the range is anything from .75¢ to \$2.80 per \$1.00 of contracted revenue per annum. Frankly, I have never really understood this method of valuation and I have always been puzzled why strata management businesses were not valued the same as other businesses, namely, on a multiple of profit.

*There is a real chance that the traditional approach to valuation of strata management businesses will be set aside in favor of a more conventional approach.*

If strata managers do as I suggest above and focus on the attractiveness of their businesses to a buyer, then I think there is a real chance that buyers will approach this valuation process

more along conventional lines. In turn, this will put pressure on sector financiers to reassess the way they value strata management businesses for funding purposes. This could make available much needed capital for some managers to invest in the technology and processes they need to make their businesses more scalable and suitable for expansion.

## Conclusions

The drivers for consolidation of the strata management sector are such that there is a high degree of inevitability about the process occurring. When the process does occur it will drive much needed change throughout the sector. Customer service levels and the profitability of strata management businesses will be improved and this will lift the value of these businesses.

Like most periods of structural change, there will be threats and opportunities. For those strata managers who successfully identify and take up the opportunities there is the potential for substantial rewards. For those who choose not to believe, or who ignore the process, their businesses may become a victim of that change.

I regard this period of change as very important for the future of the strata management sector and I look forward to observing the change in progress. I encourage all strata managers to carefully consider the opportunities that will become available and to position themselves to obtain maximum benefit from this period.

*There will be much needed change ... customer service levels and the profitability of strata management businesses will be improved, as will be the value of these businesses.*

**Gary F Bugden**

March 2006