

The Troubled Condominium Workout

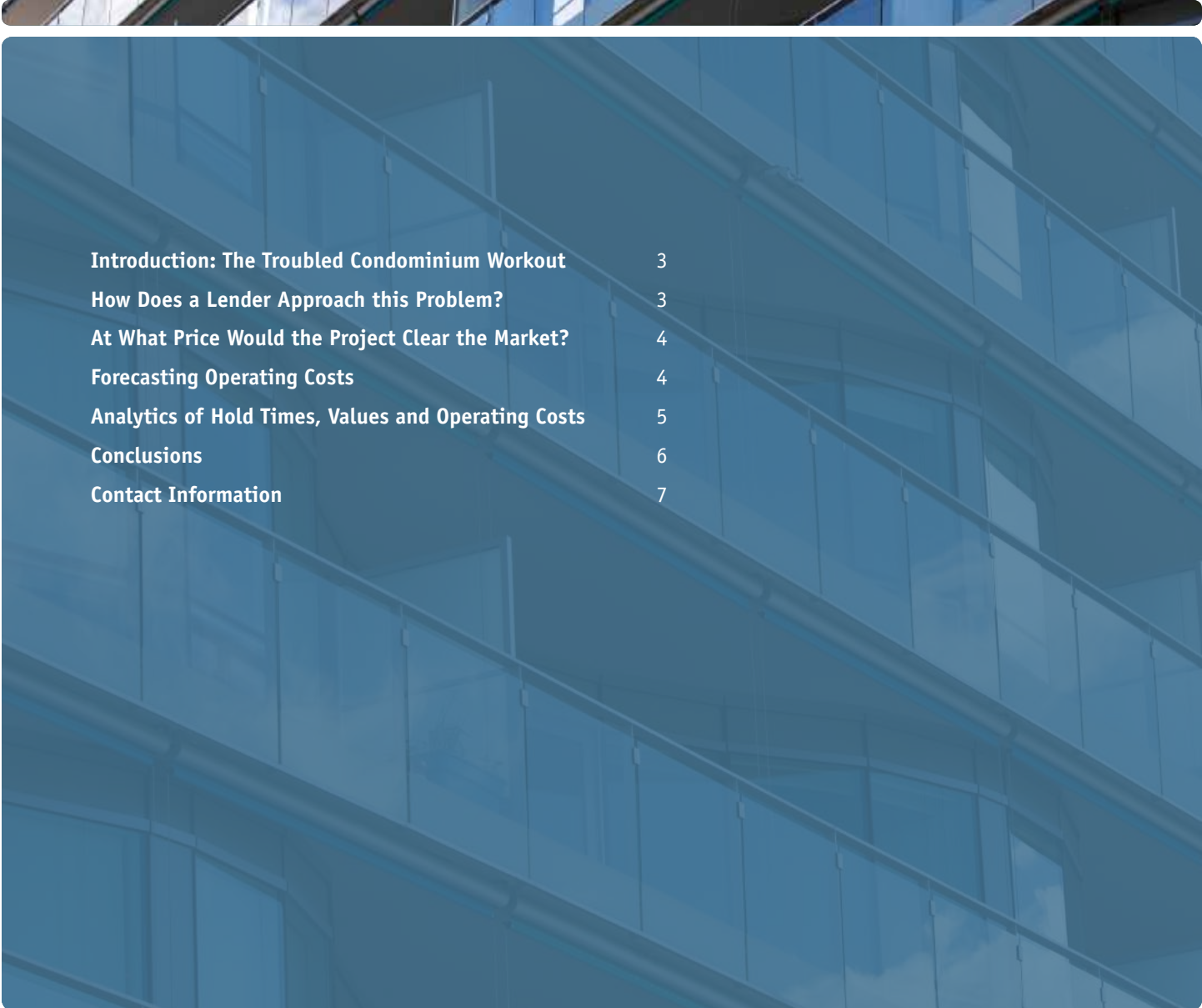


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Introduction

The explosion of condominium construction from 2002 to 2007 is continuing to create some unique problem loan situations today. Following the real estate market collapse in 2007, countless condominium developments have run into financial distress and failure due in part to collapsing demand and resultant oversupply of such units in the market. Initially most lenders worked with existing ownership to attempt a restructure, yet many condominium towers remain incomplete, units remain unsold, and condominium home owners' associations (often referred to as "HOA" or "COA") deficit operations continue. The common thread is that lenders are being asked to fund failed condo development completion costs and owner associations operating deficits, yet a positive performance outcome continues to elude all parties.

A recent example that illustrates this situation involved a Lender to a condo developer with two related buildings in a resort area. The 40 unit buildings were originally developed to be condominium mid-rise towers appealing to the second home or investor purchaser. In this example, both buildings were completed in 2007. Currently, Building One has 15 units sold and 25 unsold units. Building Two has sold eight fractional share ownership units and the remaining fractional shares are unsold. The lender has been working with the owner from 2007 to 2011. The buildings are currently being leased by the night as vacation rental properties. The lender is not receiving interest or principal payments and is being asked to fund ongoing operating shortfalls. In addition, the wear and tear on the collateral is continuing and deferred maintenance is accruing.

For this lender, it is difficult to imagine an appropriate workout strategy.

How does a Lender approach this problem?

Unfortunately outcomes which result in lenders recovering their total outstanding loan balances in failed condo developments are rare. Typically a lender must make difficult choices in such situations.

The first question to be answered is "At what price would this project clear the market?" This requires the lender and its advisors to actively pursue a third party buyer to determine the market floor. Before additional decisions regarding funding operations and collecting interest can be made, the lender needs to understand the true current value of the property – the cash price a buyer would be willing to pay in today's economy.

The second question relates to the market price established in answering the first question, namely "Is the lender able to absorb any loss required to clear the market at the third party price?"

If the answer to the second question is "no" then the Lender will need to fund operations and employ management talent to ensure the collateral is maintained.

If the answer to the second question is "yes" then the lender should evaluate the outlook for market conditions and offset any potential gains associated with a hold strategy against operating costs which will need to be funded during the hold period. If the lender perceives a positive net gain over the hold period, the lender may elect to hold the asset for a period of time and fund operations. If the lender perceives an additional net loss, the Lender should move to sell at the current market price.

At What Price Would the Project Clear the Market?

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Lenders are required by law to receive FIREEA-compliant appraisals on real estate held as collateral. During the recent real estate downturn many appraisals established values with the caveat that the highest and best use of a particular property would be to hold the property until more normal market conditions return. More normal market conditions, in this case, means there are more willing buyers active in the marketplace. The appraisal, therefore, establishes a value of an illiquid asset, while the lender is interested in the value at which the collateral can be converted to cash. As a result, lenders need to consider other avenues for testing values.

One approach is to request a Broker Opinion of Value (BOV). The key to this approach is to engage a broker that has specific experience in the collateral's product type, comparable sales in this product type and geographic market, and marketing successes.

Another approach is for the lender to review its own loan portfolio for recent sales of the product type in the geographic market.

A third approach is to hire a Financial Advisor to consider all the aspects mentioned above, plus provide an independent view of the local market conditions. This expands the review beyond an analysis of sales and re-sales, to include further analysis of market conditions and the operations of the specific collateral. This approach also provides a smooth transition to the comparison of hold time, projected value, and ongoing operating costs.

Forecasting Operating Costs

Imperative to the analysis of hold time, project value and ongoing operating costs is the ability to effectively forecast operating costs. Typically a development is run by a prop-

erty management group (PM) hired by the original developer until such time that the management of the building can be transferred to the unit owners based on the condominium Declarations. To assist in preserving value, the lender needs to understand the owners' association operations.

While the property management group is purported to be a third party, the decisions that a PM makes are driven by the Board of Directors of the HOA – usually the original developer, who typically serves as the HOA president until the Declarations allow the transfer of management to the unit owners. As a result of this symbiotic relationship, the level of deferred maintenance may not be openly shared with the lender. Perhaps maintenance on the elevators or the roof (two areas difficult to assess) has not occurred and is negatively impacting recovery value.

Other potential problem areas are association dues and real estate taxes. The owners' association manager should know which owners are delinquent in the payment of association dues, property taxes, etc. Often the original developer is one of the owners who is delinquent on association dues. This can result in reduced recovery to the lender as units sell, because unpaid association dues must be remitted to the HOA or COA upon sale of a unit.

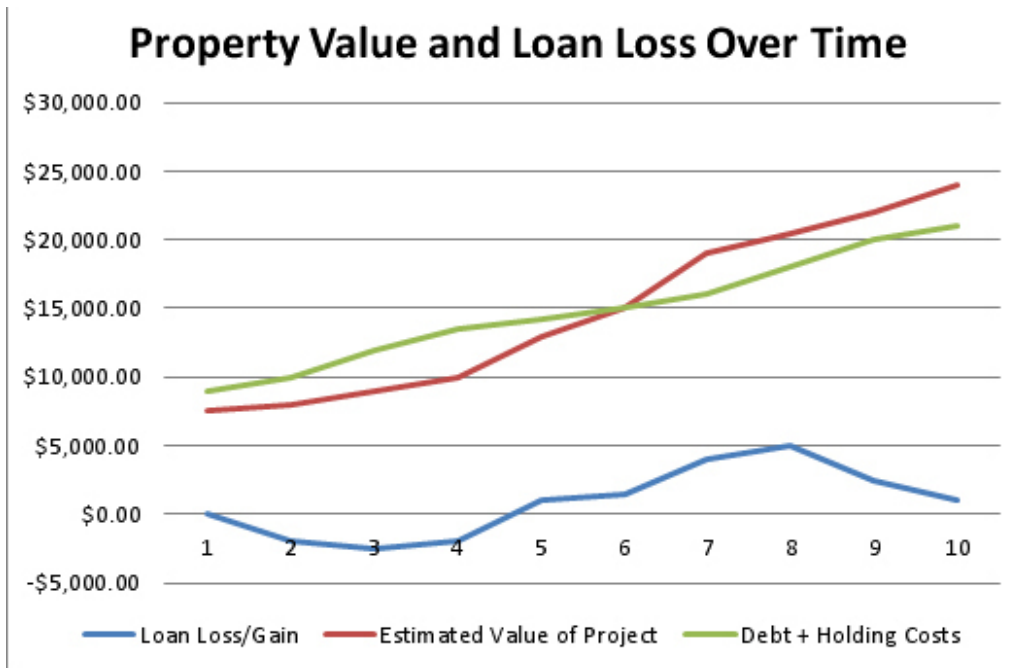
The board of directors of the HOA instructs the owners' association manager and influences the operating rules of the association, which establish cost structures and maintenance plans. A developer may be keeping HOA or COA dues artificially low to reduce the payments upon sale to the HOA or COA. However this creates a situation where operating costs may be unfunded and pushed to the lender. Alternatively, the HOA or COA dues could be increased to bring more cash in from the third party owners immediately, while reducing future recoveries from unit sales.

How Should Lenders Move Forward?

Often, the Board of Directors for the owners' association needs to be formed and brought up to compliance with the Condominium's Declarations. Condominium laws are different in each state and regulations regarding proper management of an owners' association often require a professional manager to ensure compliance. Legal counsel skilled in condominium law may need to review the current status of issues facing the owners' association. These areas can result in legal fees which developers may elect to avoid, thereby creating legal problems that lenders are left to solve in the future.

Analysis of Hold Times, Values and Operating Costs

The lender or the financial advisor needs to use the information described above to develop a graph comparing hold times to net values. The table below is an example of the outcome of this type of analysis.



The example represented in the graph above depicts a property with a current market value of \$7 million and a current debt balance of \$9 million. It assumes that the market value will improve rapidly during years four through seven. It also assumes that debt and holding costs will increase by 10 percent per year.

This type of analysis helps illustrate the challenge which lenders have to resolve regarding the difference between current appraised values and market clearing values, and the costs to carry real estate assets. In the example above, if a lender believes these assumptions for market changes are real, the lender would likely opt to incur the holding costs for the next 5 years in order to have an opportunity to sell at break-even or at a gain in years 6 and after. The key risk lies in the assumptions used to determine market appreciation, compared to the hold costs.

Conclusion

Conclusions

Condominium workout situations are not easy – either for the lender, the developer, or the current unit owners. Lenders are confronted with seemingly impossible to overcome property development situations – complicated to unravel, difficult to understand, expensive to fund. The use of a third party financial advisor provides an opportunity for a second set of eyes with established property management skills to review all aspects of a condominium project and provide risk assessments related to the current operations, as well as future operating assumptions.

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