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Vultures Circle Condo Market

Written by Parke M. Chapman

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Jack McCabe has a sure-fire way to make a killing in Florida real estate. No, he's not joining the throng of speculators in downtown Miami who are snapping up blocks of condominiums in hopes of flipping the properties quickly. And no, the real estate analyst from Deerfield Beach, Fla., isn't acquiring apartments in order to convert them to condos for a handsome profit.

McCabe has other ambitions. He wants to raise several hundred million dollars for a "vulture" fund that plans to snap up distressed condos in Florida within 12 to 15 months — maybe sooner. Of course, much depends on when the high-octane condo investment market begins to run out of gas.

"It's clearly a problem waiting to happen when you see these unsophisticated people get into this risky business," says McCabe, who has encountered everyone from taxi drivers to dentists jumping into the condo investment arena.

Miami is the kingpin when it comes to new condo construction. Developers plan to add more than 70,000 new condo units to the area over the next three years. That's nearly three times the number of condo units that have been built in Miami over the last three years. For now, there appears to be plenty of demand — especially from the most inexperienced investors.

A national phenomenon

Although South Florida has become the poster child for the condo craze, other markets are experiencing plenty of construction activity. According to Michael Cohen, a senior real estate economist at Boston-based Property & Portfolio Research, a flurry of new condo units are popping up in cities such as San Diego, Chicago, Las Vegas and Washington, D.C. Much of that supply is the conversion of apartments into condos (see *table*).

In Chicago, for example, as many as 3,500 apartment units will become condos this year, based on data from Chicago-based Appraisal Research Counselors. That would exceed the previous record set in 1994 when a total of 2,424 apartments were converted into condos.

Speculators are major players in Chicago. Appraisal Research data reveals that up to 30% of the Windy City's condo units were sold to speculators this year.

A similar story is unfolding in the nation's capital, where conversion activity is going strong. Transwestern Commercial Services data shows that 91% of all D.C. metro area apartment buildings sold through the end of May were bought by condo converters. In 2004, converters snagged only 51% of all apartment deals, up from 28% in 2003.

Internet fuels the fire

Several new Web sites are exploiting the condo craze, making it easier for anyone with an Internet connection to become a speculator. In July, for example, Miami real estate broker Mark Zilbert unveiled CondoFlip.com, which enables buyers, sellers, brokers and developers to flip condominiums before they are even built.

Zilbert says the response is so strong that he plans to expand the concept to markets such as Las Vegas, Dallas, New York and Los Angeles within 12 months.

Another Web site that launched this summer is USCONDEX.com. The online exchange bills developers \$2,500 per building every month to feature existing or soon-to-be-built condos. The site plans to launch live auctions of condo properties later on this year.

McCabe predicts that Web sites geared toward flippers will only prime the market by luring investors from other states or countries to buy condos. It's likely to boost the number of buyers executing sight-unseen deals, which already stands at 20%, according to McCabe. He also predicts that the Internet will play a significant role in hastening and deepening a crash.

Raising capital is a snap

In the meantime, McCabe is busy raising money for his first vulture fund. He claims that several wealthy families and established financial institutions have expressed interest in his fund. They want in — and McCabe expects others to follow — so he has doubled the minimum stake from \$250,000 to \$500,000 in recent weeks. The fund will target blocks of new condo units owned by investors who anxious to sell.

McCabe isn't alone. New Jersey-based real estate investment firm Palisades Financial is waiting to capitalize on any distressed assets. In January, the firm will launch a series of \$100 million funds that will partly focus on distressed and value-added investments nationally. About 30% of those funds will flow into distressed assets, including condo units. The balance of the funds will be invested in value-added properties.

"The capital markets will throw money at developers, and the developers will build," predicts Billy Procida, CEO at Palisades Financial, who fears that a condo meltdown is likely. "This has happened before. Put it all together and the southern Florida market will fizzle out."

For vulture investors that structure their capital-raising efforts around a market collapse, timing is almost everything. But it's far more complex than just hitting the market bottom with a solid war chest of capital, says Doug Poutasse, chief investment strategist at Boston-based AEW Capital Management. AEW manages roughly \$27.5 billion in real estate investments for some of the nation's largest pension funds.

"The vulture investors are every bit as speculative as the people speculating on condo units today," he says. "And the problem is that it can take many, many years for these condo markets to recover. These are tricky assumptions to make."

There's also the question of competition. According to Poutasse, roughly \$20 to \$30 billion of capital is sitting idle in U.S. opportunity funds today. It is not likely that all of that capital will pour into depressed condo markets, but a sizable portion of it most certainly will. "A lot of people are talking about setting up vulture funds tailored to certain markets and property types right now," he says.

Lessons learned

Florida is certainly no stranger to condo booms and subsequent busts. In the mid-1980s, for example, offshore investors ditched their condo deposits after an economic downturn swept through Latin America. The banks that inherited these condos through foreclosure were forced to significantly discount the properties prior to sale. Developers typically use the proceeds from the sale of each condo unit to repay their construction loans.

"This is a market-by-market story, and we pay attention to job growth, high single-family home prices and population growth," says Cohen of Property & Portfolio Research. "In the most expensive single-family home markets, many condo developers are providing the low-cost entry into these markets through their projects."

Lenders appear undaunted

For the moment, lenders aren't shying away from big condo deals, despite a torrent of media reports about the housing bubble. If anything, lenders say, demand to finance both conversions and ground-up construction has increased over the past seven months.

Sonnenblick-Goldman, for example, will finance more than \$500 million in condo conversions this year, and much of that will be earmarked for conversion projects in Florida. Executives at the New York-based real estate investment

bank believe that the conversion of apartments into condos poses less credit risk than building condo projects from the ground-up.

It's all in the timing. "It doesn't take us nearly as long to convert from an apartment to a condo," says Andrew Oliver, managing director and principal at Sonnenblick-Goldman. "We can turn that apartment around very fast, and that helps cut the risk of missing the market."

A typical condo conversion takes six to 18 months on average to complete. Many urban developments, by comparison, require years to complete due to cramped building conditions and complex zoning laws. Zoning isn't such a problem when converting from apartments into condos, says Oliver, unless the developer is adding additional floors to the building.

If Oliver is a prudent player, he may be one of the few. Lenders aren't showing much restraint in financing these deals. Condo converters bought \$13.3 billion worth of apartment properties last year compared to only \$3 billion in 2003. What's more, many converters carry floating-rate debt at a time when interest rates are climbing. But floating-rate debt may be the least of their problems, if the market sours.

Risky business

Fitch Ratings warned in July that many lenders are executing complex, thorny condo conversion loans. And proving that ignorance may be bliss, many have chosen to overlook the inherent risks of these loans in favor of getting deals done.

This could end badly for many lenders. Fitch Ratings predicts that around 10% of all condo conversion loans originated in 2005 will ultimately default. That's a huge number given that only 2% of all multifamily loans originated this year are expected to default.

"These properties don't generate a sustainable cash flow, and another problem is that developers are having trouble completing these conversions on time and on budget," says Zanda Lynn, a director at Fitch Ratings.

As one Manhattan-based lender sums it up, competition might be forcing some firms to take on more risk than they can handle. "Some of these lenders in south Florida are getting stretched. They've got one developer doing multiple deals, and each new project is riskier than the last," says the lender, who asked not to be named.

Cohen also credits relaxed lending standards for driving condo demand in markets such as San Diego, Las Vegas, Miami and Washington. With lenders under pressure to make loans, a variety of unconventional debt tools have gained popularity within the past 18 months.

In July, Wells Fargo & Co. started allowing buyers of investment properties to take out interest-only (IO) loans. The typical IO loan enables borrowers to pay back interest and no principal in the first few years of the loan. If price appreciation stalls and the borrower can't sell at a profit before the principal payments kick in, there could be a problem. "It's important for investors to understand the risks, but many either don't or choose to ignore them," says Cohen.

Ignorance is not bliss

Generating any cash flow during a conversion can be tough. The reason is that many condo projects rely on skimpy deposits from buyers in order to secure financing. As Lynn of Fitch Ratings notes, these deposits — which may amount to as little as 10% of the entire loan — are spread even thinner when renovations exceed the original budget.

Another risk that borrowers often fail to consider is local market conditions, says Lynn. Since each market poses different bureaucratic challenges, the time needed to secure approval for a project can vary by as much as a year. In New York City, for instance, the time to receive an approval has doubled from three to six months due to a backlog of conversion applications.

Aside from red tape, many investors naively assume they can pull off a condo conversion. The problem hinges on the fact that many novice investors buy apartment buildings as a starter property. But the transition from managing rental apartments to coordinating an involved condo conversion can be arduous.

"Running a small apartment building is one thing," says Lynn. "But now many people figure that condos are as simple, and the competitive market for loans is helping them become converters."

Some apartment owners overestimate the number of renters that will opt to jump on the condo bandwagon. Ron Witten, president of Dallas-based multifamily consulting firm Witten Advisors LLC, says that on average only 10% of apartment tenants choose to buy their unit as a condo. "That makes it less easy to fill a conversion fast, but a lot of landlords assume that more will go ahead and buy the converted units," he says.

Still, there is no question that there is significant demand for real estate. The National Association of Realtors reports that 23% of all homes bought in the U.S. last year were purchased by investors with no intention of occupying them. Another 13% of all homes sold last year were bought as second homes.

"The investment market really runs hot and cold," says John Kriz, senior managing director of Manhattan-based Fitch Ratings' real estate finance group. He admits that while it's tricky to predict investor psychology in a downturn, investors, developers and lenders should be proceeding far more cautiously.

McCabe's vision

McCabe, the Miami-based real estate analyst, says that he expects his first vulture fund to be active by early 2006. He envisions doing several large acquisitions — be it purchasing blocks of condo units from one developer or individual units from several investors — through this first fund.

McCabe expects to return his investors' initial stake, plus a 100% profit on top of it. That's after McCabe has taken his cut as an advisor to the fund.

The one thing that McCabe makes clear is that no profits will be distributed until the portfolio of bargain-bin condos is ultimately sold. What's less than clear is how long it will take McCabe to deliver on that promise.

"I plan to hold these units for anywhere from five to seven years," says McCabe. "But things are moving fast in south Florida, a lot faster than I had expected."

Parke M. Chapman is senior editor.

CONVERSION MECCAS

The total number of apartment units bought by condo converters, and the total dollar value, has risen sharply year over year in the following five major metropolitan areas.

City	Number of Units Converted		Value in Millions of Dollars	
	2004	2005* through June	2004	2005* through June
Chicago	448	2,156	\$39.4	\$474.8
Las Vegas	2,070	3,255	\$147.7	\$408.9
Miami	4,866	5,588	\$676.5	\$660.3
San Diego	2,338	2,439	\$422.7	\$487.1
Washington, D.C.	157	820	\$43.4	\$262.9

*Figures for 2005 are through June. Figures for 2004 are for the full year.

Source: Real Capital Analytics

Investing for the long haul

Not all Florida condo investors are bent on the quick flip. Just ask Kenneth Balin, CEO of Philadelphia-based private real estate investment firm AMC Delancey, who is developing a \$280 million condo development 300 miles north of Miami. "We're prepared to hold properties for the long term, and that makes us different from many of the investors today," insists Balin, who has generated double-digit returns on previous condo investments.

Balin typically maintains an interest in a condo development's retail component for several years after a project is completed. That's a different strategy than most condo developers, who typically relinquish their full stake after all the units have traded.

"We structure our real estate transactions with the best local operating partners in such a way that if the bubble bursts, we are insulated," emphasizes Balin. So, what makes his 450-unit Anastasia Island project near Saint Augustine less vulnerable to the boom-and-bust cycles of the condo market?

First, the project will consist of low-rise buildings spread over a 132-acre parcel of land. And roughly 70,000 sq. ft. of retail and commercial space will also be developed. Those two factors should make the project somewhat unique, Balin believes, compared with the bursting supply of taller condo projects popping up in the big Florida cities. With 70,000 condo units on the drawing board in the greater Miami area, Balin finds it hard to believe that there is sufficient demand for all of the new condo units planned or under construction.

What's more, Balin observes a stark contrast between the outlook of younger investors and industry veterans.

"None of these people in their mid-30s have ever lived through a recession before," says Balin, who developed his first condo project in downtown Philadelphia in 1979. "They're too bullish, they believe it will never end. I'm 54 years old, and I can tell you that there will be plenty of blood on the street in places like south Florida."

— Parke M. Chapman

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