

November 13, 2007
By Norman Radow

The business of rehabilitating distressed condominium assets changed dramatically this past year in tandem with the residential market. The biggest threat is the market itself. Fixing execution, legal or physical problems or repositioning an asset alone cannot create a market for a development when the market itself is in distress.



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In a good market, a developer can often get away with mistakes. In a post-bubble market, these mistakes take on a steroid quality and grow unhealthily--and can harm and even kill the best-intended plans.

This change in market dynamics now makes us pause as we determine how to best restructure or reposition a distressed condominium development. Today we have to examine seriously if the condominium process should proceed at all. Instead, converting a condominium to a rental property, also called deconstructing, must be considered. Apartment rents are rising due to a variety of factors, but they are not yet high enough in some markets to justify new construction. Potential home or condominium buyers, less able to secure easy credit, are renting longer. As a result, supply will continue to tighten.

Meanwhile, debt is pursuing apartment product aggressively, as is mezzanine and institutional equity. All of this has led to improved apartment performance coupled with cap rate compression, notwithstanding the recent hiccup in the CMBS markets.

Consequently, careful analysis needs to be undertaken to determine whether leasing is a better solution to the continuation of the condominium process. The question is easier to analyze when a condominium has yet to start its closings. It is far harder when some units have already closed. A project that has started closing units is fractured until sold units can be repurchased or the condominium

marketing is restarted. It is the fractured deal that requires the greatest finesse; poses the greatest risk; and, some argue, offers the best opportunity for reward.

A developer looking to acquire a fractured deal needs to study the answers to several questions: What is the value of the property as a fee-simple apartment? Can the remaining units be rented and the deal's cash flow as a fractured condominium? And, if so, should the developer accept the legal risk of managing this cash flow when time constraints imposed by the condominium documents may cause management issues and fiduciary liability in the future? The answers to these questions must be weighed against the cost and difficulty to re-image a property in order to conclude its sellout as a condominium, juxtaposed to the costs and practical difficulties in buying back previously sold homes.

No matter the strategy one chooses to employ on a fractured development, be it implementing a plan to reinstate the property as fee simple, continuing the condominium process or managing the deal as fractured, the process is complex and fraught with both practical and legal difficulties.

Buying back units in order to deconstruct a condominium is not for the faint of heart. One holdout can thwart a developer's attempt to recreate the fee-simple parcel in order to manage it solely as an apartment. Another route is legal. The developer can vote its shares to void the condominium. This assumes the developer has the votes to do so, yet even then a tenant-in-common relationship emerges that will require a court-ordered separation in order to recreate the fee, which can be emotive and expensive.

Continuing the condominium process presents its own issues and challenges. If the property is being re-imaged, will it change the tenor of the project enough to cause a backlash from the existing owners?

Our firm recently entertained a lawsuit by homeowners who challenged the repositioning of the property. The owners asserted that the change in amenities and some common areas--including actual improvements to the property as opposed to deletions from previous plans--breached implied representations made by the previous developer. The owners also asserted that we, as the second developer, were a "successor developer" under that state's condominium statute, subjecting us to liability. The owners lost, but the resolution took time, money and Tums.

Managing a property as fractured requires a developer to juggle the needs and management expertise required for a rental property with the maintenance of his fiduciary obligations and responsibilities to existing owners. This includes paying dues on all unsold units, keeping separate association books and records, providing services required by the condominium documents and calling meetings. Also, after the time set forth in the condominium, the developer loses automatic control of the property and needs to vote, with the existing owners, on many operational matters. At the very least, each strategy employed in a fractured deal has its own unique challenges.

In today's market, continuing with a condominium sales regime needs more thought and finesse as well as excellent execution. A confidently marketed property and sure-footed sales team consistently outperform in a down market. Developers may find their pro formas further affected as they spend more critical dollars on marketing to compete and win during this challenging real estate cycle.

No matter what strategy the developer employs to continue with a sellout of a fractured condominium, the days of the developer as a gatherer of sales is over. In this market, only a hunter will survive. Taking on the challenge of fractured condominiums will require a different breed of developer; one more risk averse, but who understands it, coupled with the necessary experience and financial resources to make a fractured property successful.

The views expressed in this article are those of the author and not Real Estate Media or its publications.

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