

MULTI-HOUSING NEWS

THE NEWS AND INFORMATION SOURCE FOR THE MULTI-HOUSING PROFESSIONAL

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EXECUTIVE INSIGHT

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Michael S. Rodgers, an attorney in the Atlanta office of Seyfarth Shaw LLP, provides counsel to local and international residential developers. He recently has worked with a number of clients who have decided to devote part of their new apartment developments to condominiums. He discussed some of the factors driving this trend, and some of the legal issues it generates, with *MHN's* executive editor, Keat Foong.

MHN: You have observed a recent trend in which apartment developers are allocating portions of their developments to condominiums. What's causing this?

Rodgers: The primary reason is diversification of risks. What apartment owners are finding in the current low-interest rate environment is a lot of their traditional customer base is deciding to purchase condominiums. We are seeing, particularly in the Southeast and in many metropolitan areas across the country, a decline in occupancy rates in apartment complexes and higher demand for condominiums.

So apartment developers are looking at this strategy as an opportunity to do two things. One, wade into condominium development and not entirely leave the apartment business. It is a way to diversify risks by being able to gauge the market demand for condominiums and apartments at the same time, and to determine if the condominium market is strong enough to justify having the entire complex being sold as condominiums.

The second reason we are seeing apartment developers working in this manner has to do with the financing costs

associated with the construction loans for condominiums. If they have too many units planned, the market absorption rate may not be quick enough to offset the interest rate they are paying on their development loan. By retaining a portion of the product as apartments, they are able to maintain an income stream on the property to help pay the interest carrying cost until the market absorption rate will take down the rest of the project.

MHN: What are the major legal complications associated with dividing your new build between apartments and condominiums?

Rodgers: Of course, there will be the traditional condominium owners' regime created for the condominium units, and those condominium documents will reserve the right for the developer to expand the condominium to annex the traditional units over time. So the lawyer engaged to draft the condominium documents would have to work with the client, understand the timetable and understand how they are likely to annex additional units over time.

One also has to consider that it may take some time for other phases to be created as condos, or ultimately that may never be the case. So we have to create another set of covenants and easements—what we call reciprocal easement agreements—dealing with common and shared amenities until the apartments are annexed into the condominiums. This reciprocal easement agreement addresses how the two parties are to share common amenities and maintenance costs.

The lawyer will need to work closely with developer and architect to understand all the issues where there would be the possibility of sharing, and what those parts are that have to be allocated between the two types of ownership.

To read the complete interview, visit the Executive Insight section of www.multi-housingnews.com.

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Taking the For-Sale Leap

Entering the Condo Development Game Can Be a Highly Lucrative, But Tremendously Tricky Move

By Keat Foong
Executive Editor

Atlanta—So you are an experienced apartment developer, and you want to put up a condominium project, huh? Okay, you do your due diligence, research the market, and it appears area income levels support the projected selling price. So everything is fine, and you can build the condos with the confidence that buyers will form a line around the block, right?

Wrong. Developers accustomed to putting up for-rent multi-housing would do well to educate themselves very, very carefully before they enter the for-sale field. As Ron Terwilliger, chairman and CEO of Trammell Crow Residential, said, "If people think condominiums are the same business as apartment development,

FOR-SALE REPORT: PART II



Trammell Crow Residential is developing the 270-unit Buckhead Village, located on West Paces Ferry and Peachtree Road in Atlanta.

they are making a big mistake. There are many things that you need to do differently."

Welcome to the world of for-sale multifamily development. Given soft rental markets, low interest rates and the seemingly insatiable appetite for home purchases nationwide, many apartment developers are looking to jump into the for-sale business.

But in many ways, developing a community for buyers and developing one for renters are only distantly related endeavors. The customer of for-sale multi-housing is markedly different from the renter, so the product needs to be as well. The financing process, too, is dissimilar and so is the marketing. And there are also plenty

Taking the For-Sale Leap

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to adequately fund reserves for the homeowners' association; and failure to comply with regulatory disclosures required by statute.

Among these potential claims, construction-defects litigation is one of the biggest concerns. "The one area in which dissatisfaction always occurs—the one area where buyers seem always unhappy—lies in construction-related issues," said Owen.

This provides all the more reason for developers to be very careful during construction and to hire quality contractors and subcontractors in for-sale housing. Humphreys, for example, brings waterproofing consultants onto the job site to review the construction process. Although the architect's plans can be correct, he said, workers can install items incorrectly. For instance, he said, balcony railings can be installed so tightly as to puncture the waterproofing underneath the floor.

For-sale developers can obtain wrap insurance to protect themselves against litigation—which can be brought long after the final unit is sold. In California, for example, buyers can sue for construction defects up to 10 years after they purchase the home, said Warren Griess, vice president at the Los Angeles office of **Love Funding Corp.** Wrap insurance can be very expensive, however, running as much as \$500,000 in total, he said.

There are other ways developers can protect themselves. Picerne's Miller suggested that developers consider hiring third-party general contractors to perform the construction. "The more layers between the developer/owner and resident, the better off you are," he pointed out.

As far as mitigating litigation risks in condominium documents, Owen advised developers to be very careful in understanding the terms and conditions contained in the homebuyers' warranty and to avoid taking on unanticipated liability resulting from common law that is not expressly stated. They should also try to match as closely as possible the warranty they provide to the homebuyer with the warranty obtained from their own contractors, he said.

Owen recommended that developers write into the declaration of condominium a rule that requires the homeowners' association to obtain approval from the majority of investors before filing any lawsuit. This will avoid any frivolous litigation brought about by a minority of dissident residents, he said.

It is also very important, advised Owen, for developers to try to make full disclosures in the documents. For example, in Chicago, the developer is liable to be sued by the homeowners' association for replacement costs if it is not disclosed in the condominium statements that he did not fund the reserves. "In Chicago, if you disclose that you're not providing any reserves, that's fine—you do not have to fund the reserves—but disclosure is key," said Owen.

Condo Capital

Another major component of a for-sale development project is, of course, financing. Sources say both debt and equity are readily available today for condominiums and townhomes—for developers with strong track records. Nevertheless, there are aspects of for-sale multi-housing financing that developers need to be aware of.

Construction financing for condos and townhomes has to cover the time it takes to build, market and close on the sales of the units, said Love Funding's Griess, who pointed out that the development of for-sale multi-housing is typically a longer process.

It takes a buyer at least 60 to 90 days to obtain the financing and close on a

deposit; the other requires buyers to sign a binding sales contract and place a significant deposit. Lenders tend to prefer to see buyers sign binding contracts and place significant deposits—typically, 10 percent when the sales contract is signed—before the commencement of construction, said Kaplan.

However, in extremely hot markets with continually rising prices—in California, for example—the lender may waive the presale requirement. This enables the developer to sell the units for even higher prices and avoid inad-



Adrienne Albert, of The Marketing Directors, advises developers to be as specific as possible in creating a product to meet a niche in the marketplace.

vertently leaving money on the table by going into contract too soon.

A condominium construction loan also differs from a loan for apartment construction in that the bank is paid back as the units are sold. Developers should be aware that there are many loan repayment schedules, some more favorable. Griess explained that under the "net proceeds" option, the bank can take 100 percent of the net proceeds of each sale. The developer recoups none of his profits from unit sales until the development is about 70 percent sold out—when the lender is totally repaid. Under the "125 percent release price" option, on the other hand, the bank will take 125 percent of the construction cost per unit, and the remaining balance is funded to the developer after each sale.

Marketing & Profitability

Developers such as Terwilliger, Miller and Pollack, all of whom have considerable experience in selling for-sale multi-housing, agree that catering to the multi-housing buyer is a very marketing-intensive process, and that it requires a more service-oriented organizational culture.

In fact, the marketing process involved in selling multi-housing is "completely different" from that involved in renting apartments, according to Adrienne Albert, president of **The Marketing Directors**

Inc., a New York City-based marketer and exclusive sales agent for both for-sale and for-rent residential properties. Both rentals and condominiums need brochures, a sales office, signage and advertising, said Albert. However, the marketing of for-sale multi-housing is "more extensive. It has a different tone and attitude," she noted.

For example, in the case of marketing condominiums, sales agents need to stay with potential buyers over a longer period of time. "We've seen in our offices most people buy on the second or third visit, and some require as many as five visits. Rental decisions, by contrast, happen on the first or second visit," she said.

Nevertheless, Albert said the same sales agents can certainly be used to interact with both renters and buyers. The differentiating quality comes down to the agent's experience or knowledge, she said, but a sales agent "can jump the line from one to the other" with a little education.

Another major difference in marketing for-sale multi-housing is that developers may have to be prepared to spend considerably more money in advertising. According to Albert, apartments tend to be listed in classified ads, while for-sale condominiums or townhomes are advertised through display ads that offer a greater potential for differentiating the product.

Consequently, while a classified ad for a rental may cost, say, \$3,000 to \$5,000, an ad for a condominium may cost as much as \$15,000 to \$17,000—the cost of a quarter page advertisement in the *New York Times*, said Albert. "During the first weeks the condominium is open, the differences in advertising cost can be substantial," she said.

In developing condominiums, developers often involve marketers early on in the planning stage. Albert advised developers to be as specific as possible in creating a product to meet a niche in the marketplace. "The product has to speak to the end user specifically," she said.

When all is said and done, some developers say that the more quickly the condominiums are sold, the more profitable the project. In fact, according to Pollack, apartments have the advantage of benefiting from long-term capital gains treatment, whereas profits from the sale of condominiums are taxed at ordinary income level. "Only in markets where things are moving quickly are condominiums more profitable," asserts Pollack. ■



There are many loan repayment schedules, some of which are more favorable to the developer, explained Warren Griess, Love Funding Corp.

purchase after the sale is negotiated—whereas an apartment renter can move in the same month. Therefore, compared to the typical 12- to 18-month apartment construction loan, condominium construction loans are typically provided for 18 months with a six-month extension option, said Griess.

Condo lenders often require that a certain number of the units are presold before they advance the construction financing. "More and more lenders throughout the United States are imposing proof of existing markets through presales," said Robert Kaplan, managing director of the Miami office of **Holliday Fenoglio Fowler LLP.**

Kaplan explained that there are two reservations systems: One requires buyers to sign a non-binding agreement and put down a minimal

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