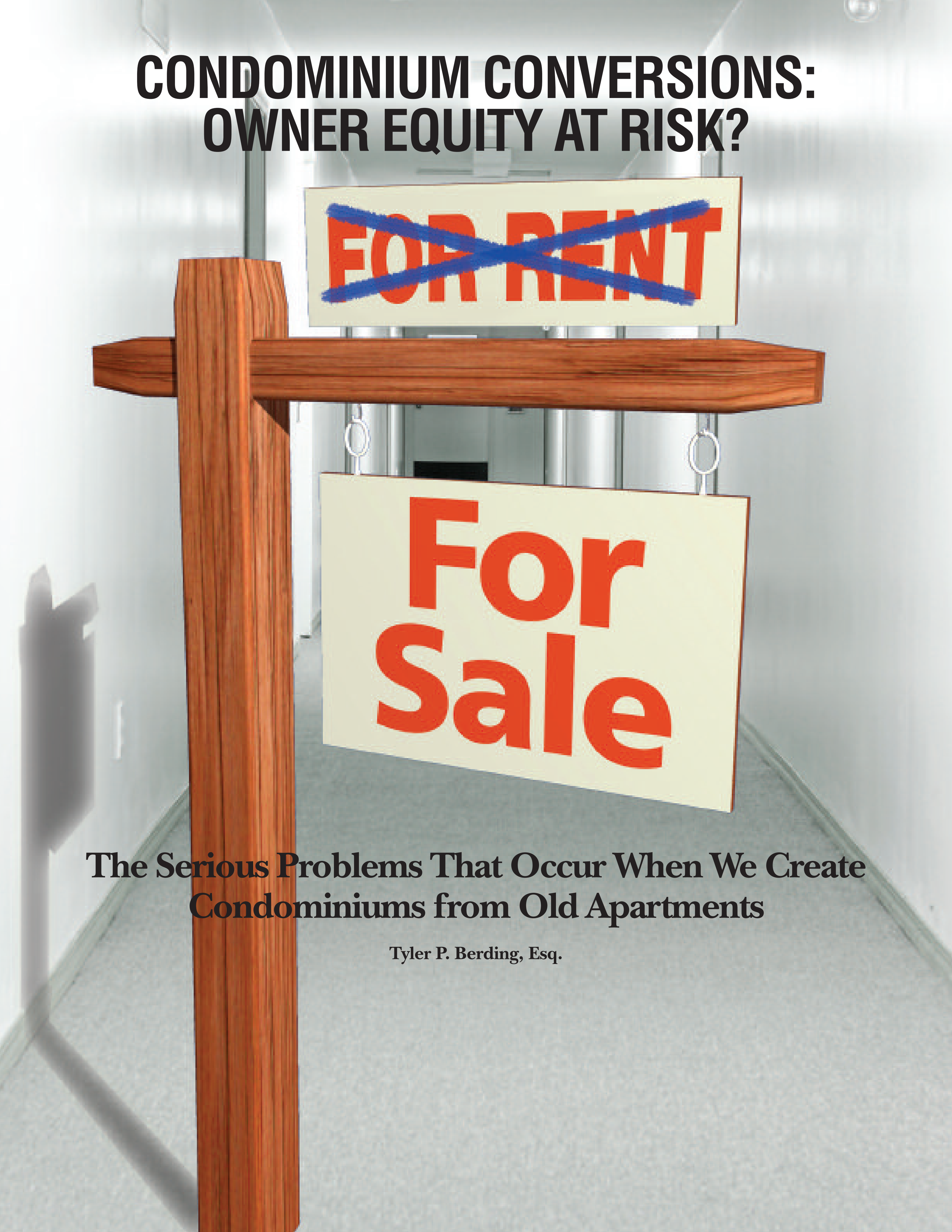
CONDOMINIUM CONVERSIONS: OWNER EQUITY AT RISK?



The Serious Problems That Occur When We Create Condominiums from Old Apartments

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Condominium conversions, a really bad idea, are here again. You don't need statistics to tell you that condominiums converted from old apartment houses have been all the rage for several years. Just look around. Numerous apartment buildings are being sold as condominiums. We saw it twenty years ago when home prices in California experienced the same kind of super heated run-up that we've seen in the first part of this decade. Anything with a door and a roof sold quickly, often with multiple offers. The market has cooled some now, but builders with homes to sell made a lot of money.

Having homes to sell, of course, is the key. You can't profit from sales without inventory, and homes can only be built so fast. With more inventory to sell, there is, of course, more profit; so the question became how to increase inventory quickly to take advantage of a hot market. You could build faster, with more crews, but the limiting factor is always available land and proper zoning. How far out into the Sacramento Valley will a commuter be willing to drive on his or her evening commute from Oakland or San Francisco or San Jose before that house in Tracy or Modesto or Salinas loses its allure? Not much further would be our guess. And since all of the available empty land is now maybe at least an hour's commute away from available jobs, some would-be real estate developers had to look elsewhere.

And when they looked around they saw thousands of apartment units in buildings in good, close-in locations. These were naturals in the hot sales market of the last few years. Further, many apartment complexes that were built in previous boom times like the mid-seventies and late eighties had now been depreciated by their owners to the point where further repair and maintenance did not make good investment sense; thus their owners were willing to sell them, especially when converters were offering much more than the properties could command as rentals.

Apartment conversions appeared to solve everyone's problems. They provided a source of low to moderately priced housing in built-up urban areas where the average price of a single family home is out of reach of many working families. Cities can improve the availability of low cost housing in a single stroke. No change of zoning, no new utilities, streets, or other expensive city-maintained infrastructure is necessary—it's already there! And most important, the city can increase property tax revenues.

PROPOSITION 13

Since 1978, the recipients of the greatest benefit from California's Proposition 13 have been the owners of residential apartments. That should come as no surprise; the apartment owners were sponsors of that initiative. The initiative capped increases in property taxes to a fixed percentage instead of following market value. Owners of apartments typically hold such properties for many years longer than owners of homes; so the adjustment mechanism in Proposition 13, which ratchets property taxes up to current levels only upon sale to a new owner, affects apartment properties much less than individually owned homes. As long as an owner remains on the title to a residential property, the assessed value of a property for property tax purposes can only be increased by something like one percent a year.

Put another way, the property taxes on apartment houses increase only this statutory maximum for all of the years they are owned by the same owner, regardless of a market value increase of many times that. The same is true for individually owned homes, but homes statistically turn over more frequently; when they do, the appraised value increases to market value more often. The result is that homeowners pay higher property taxes; therefore the more recently sold homes the city can create, the more property tax it can collect. If you convert a 200 unit apartment house into 200 individually owned homes, the increase in property taxes that results from all of those sales is too tempting for a city to resist. As a consequence, cities have shown a remarkable lack of self-restraint when considering whether to approve such developments.

Some cities have conversion ordinances that require some minimal level of rehabilitation or disclosure. Yet such ordinances frequently fail to protect the buyers. Although we have seen very high-end conversions from newer buildings that actually do not need a great deal of rehabilitation, most conversions are from older apartment buildings with years of deferred maintenance and with tragically under-funded budgets for the management of these properties. The new owners will never be able to afford to maintain the property properly due to the fact that the many converters fail to do any significant rehabilitation at all. This has the effect of dumping hundreds of thousands, perhaps millions, of dollars in unfunded liability for deferred maintenance on unsuspecting buyers. It is likely that in most cases a city inspector has given these projects only a cursory review prior to approving the development for conversion. The California Department of Real Estate has also failed the buyers of these maintenance nightmares. The budgets are submitted by the developer, and as long as they appear to comply with DRE guidelines, the projects are approved by the state.

THE HIDDEN COST OF BUYING A CONVERTED CONDOMINIUM

Budgets are only as good as the estimates of useful life for each component that will require repair. If the siding is already worn out and requires replacement, estimating that it will last 20 more years may look good to the State of California; but it isn't true and the buyers will be misled. Worse, the owner's assessments will be calculated on an artificially-inflated useful life and as a consequence the reserve for siding replacement will be grossly underfunded. Similarly, if the siding is accurately estimated to last only two more years, but the reserve budget projected is based on artificially low assessments, the community association will not accumulate anywhere near enough cash to replace the siding in that time, and again the buyers have been misled and stuck with something that they cannot hope to maintain. It is also important to note that in either of the foregoing circumstances, the owner's assessment will appear as affordable, and more low to moderate buyers will qualify to buy the condominium, broadening the market for sales. The truth, however, is that the misrepresentations of the cost of ownership that result from misstated or inaccurate reserve budgets will eventually result in a much higher cost of ownership than is indicated by the purchase price.

And who ends up buying conversions? Some of the high-end conversions are bought by owners who have the financial wherewithal to fund necessary repairs, but not many are so fortunate. It is our experience that the worst buildings end up in the hands of low or very moderate-income people who can least afford to deal with these extensive maintenance problems.

MATH AND TIME WORK AGAINST CONDOMINIUM CONVERSIONS

The buyers of a condominium built as new construction have one thing going for them that their friends who bought the condominium conversion do not—time. Newly constructed condominiums, once the initial construction issues are dealt with, will survive neglect and poor maintenance for a number of years. If a new condominium association pays at least some attention to all of the projected repair needs of a building, they will budget adequately while there is still time—perhaps ten or fifteen years or more—to save the cash to fund those eventual repairs.

The buyers of a converted apartment house, however, may find that the same components need repair or major rehabilitation, but right now, not 25 years from now, and hence with no time to accumulate the cash to do it. If you convert a 25-year old apartment house to condominiums and do not do major rehabilitation in the process, all of those years of deferred maintenance are left on the doorstep of the new owners. No reserve budget can hope to adequately head off such a grossly unfunded liability with anything close to affordable assessments. There simply is no time to save the money.

Let's say that a project has plywood siding. Let's also assume it costs about $20,000 per unit to re-side the project. If the reserve budget includes a line item for siding replacement, as opposed to just painting, a newly-built 200-unit project would have say, 20 or 25 years to accumulate the roughly $4 million that it will eventually need to replace the siding. This is possible with a well-managed funding plan and if the reserves are fully funded for most of those 25 years.

But now let's assume that the community association is formed to manage a condominium project converted from a 25-year old apartment building that has not been maintained all that well. The siding will likely be at the end of its useful life when the condominium project is sold to its lucky new owners. If the converter has not replaced the siding or seeded the reserve funds with substantial capital, the owners will face a daunting, and probably impossible, task—coming up with several million dollars in just a few short years! What community association do you know that could possibly raise that much money, either borrowed or by assessing its members, or both, in that short amount of time? Few that we know. Further, the buildings where the deferred maintenance is the worst are not the high-end projects where the owners might be able to afford a large special assessment, but rather low-to moderate income projects where the residents have little chance of either borrowing or contributing the necessary funds.

ELUSIVE EQUITY

In the example above, the $4 million repair bill distributed among 200 owners will mean that each owner has to consider that her assumed equity in her home, when based on the purchase price, is actually $20,000 less the moment she closes escrow. Put another way, the true price of the condominium just went up by a lot.

And that's if all that's wrong with this 25 year-old apartment house is confined to one component. That's rarely the case, of course. Owners who defer maintenance for a building usually don't just defer it for one component—they defer it for the entire building. All the wood products, not just siding, but also balconies, walkways, retaining walls, doors, window trim, roofs and plumbing will all deteriorate if not maintained properly or replaced when worn out, and at 25 years of age most of these components will be at the end of their useful lives. The loss of equity or diminution in value due to the cost of all deferred maintenance that must be addressed by the new owners can deal a major blow to property value once discovered.

We can create a simple formula for this loss of equity:

Present Cost of Rehabilitation (PCR) less Converter Contribution to Reserves = Lost Owner Equity (LOE)

Now if the converter were to rehabilitate the project completely—new siding, paint, trim, entry structures, balconies, roof, asphalt —putting the project into an "as new" condition, the PCR would be very low to non-existent, leaving little owner liability or LOE. Conversely, if the PCR is high and is not offset sufficiently by converter contributions to capital, LOE will be high also.

Price is usually based on perceived value, based in turn on the reasonable assumptions of a buyer. It is reasonable for a buyer to assume that the advertised price of the condominium plus the monthly assessment listed will, taken together, equal the cost of ownership. But if the hidden cost of accumulated deferred maintenance results in immediate LOE, the price advertised is not the true price, and the buyer's reasonable expectations are thwarted because she lacks information essential to evaluating the value of the property. The PCR can sometimes be so high that virtually all owner equity is wiped out, at least on paper. Consider a $300 thousand condominium purchased with 10 percent down. Equity would be $30,000. In the case of a converted 25 year old apartment complex, with $3 to $4 million in deferred repairs, it is easy to see how aggregate owner equity could be reduced to zero.

THE ETHICAL ISSUE

The prior owner of the apartment complex may have calculated that the accumulating cost of rehabilitating the buildings was in excess of any profit he obtained from renting the apartments—a losing investment. If the apartment owner doesn't rehab the buildings, rents will continue to sag. If he substantially rehabilitates the apartment complex, he may invest more than the rents he can obtain will justify; so he decides to sell. If the converter buys the complex for more than its worth as rental property and adds to his acquisition cost the cost of all necessary rehabilitation, his total development cost will not only exceed the rental value of the building but may exceed its value as condominiums. If he did all of the repairs necessary to bring the property to an "as new" (zero PCR) condition, it is difficult to see how a converter could make any money at prices that the market would accept. We suspect that the answer is that he couldn't; and therefore he doesn't do much rehabilitation and he passes most of the deferred maintenance on to the buyers as a hidden additional cost of ownership. Rarely is this disclosed or understood by the condominium buyer.

Only substantial rehabilitation will eliminate all deferred maintenance. But because, as we said, to rehab the buildings as we describe may consume most or all of the expected profit from the development, this work is simply not done. If it were to be done, the price might have to be so high that few sales would result. All of this leaves one to wonder about the economics, and ethics, of this entire enterprise. If the "converted" condominiums cannot be sold for a price high enough to allow the converter to reduce the PCR to zero and thereby justify the advertised price and owner assessments, can conversions really provide new housing without having to rely on misrepresentations to hide the true cost of ownership? Simply put, do the economics of this type of development allow an ethical transaction? We don't know, but we suspect that the ethical envelope is pushed out quite far in the sales of some converted condominiums, a situation that we plan to investigate further.

And if this is all true, what will happen to the project? An already bad maintenance situation will become remarkably worse. The actual useful life of the entire project may be way less than the length of the mortgage. A 25-year old apartment house that has accumulated a lot of deferred maintenance doesn't have another 25 years to live if nothing is done about it. Given the potential shortfall that exists in many of the conversions today; it is not likely that anything can be done about this problem except to not convert old apartments into condominiums in the first place unless the converter is prepared to make a substantial capital investment in eliminating deferred maintenance.

This is not to say that all condominium conversion projects are suspect. Many converters have invested substantial cash in rehabilitation so as to give the buyers what they expect. But others, looking for a way to turn a profit quickly, may have simply "flipped" the project and passed deferred maintenance on to unsuspecting buyers. The best way to be sure is to ask the right questions and insist on answers before closing the deal.

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