



CONDO CONVERSION CRAZE

By Joe Gose

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The low interest rate affliction that has crippled apartment fundamentals for several quarters is driving the biggest condominium conversion boom in two decades. Condo developers are swarming markets across the country, paying a premium to acquire and transform rental properties into condos.

While the successful sale of condos can generate cash-on-cash returns of between 15% and 30% or more in a matter of months for converters, the trend also enables apartment owners to cash out at the top of the market. In addition, conversions create more affordable housing in areas famous for steep single-family home prices.

How hot is the conversion trade? Through mid-May of this year, condo converters paid \$1.6 billion, or \$155,400 a unit, according to New York-based Real Capital Analytics. If that pace continues for the balance of the year, the dollar amount paid by converters to acquire apartments will easily surpass last year's total of nearly \$2 billion, or \$123,575 per unit.



"There's hardly any major or quasi-major market where condo conversions — even downtown loft-type of conversions — haven't caught on," says Arthur Nevid, managing director of investment and lending for Charlotte, N.C.-based Mountain Funding. The firm provides senior and mezzanine debt, as well as preferred equity, to opportunistic developers for condo conversions and other property types. "Everybody's jumping on the bandwagon to get into the conversion business because it seems so exciting and so robust," says Nevid. "It's a fever, and it's all over."

But a rising interest-rate environment historically has signaled the end of rampant conversion activity, and condo experts are fully aware of what's happening in the bond markets. Since bottoming out this year at 3.65% on March 17, the 10-Year Treasury yield climbed more than 100 basis points to 4.8% in mid-May, and the Federal Reserve Board continues to signal that it will raise its short-term Fed Funds Rate as the economy heats up.

A Double-Edged Sword

What's the net effect of the conversion craze on the apartment industry? While the impact will differ from city to city, conversions likely will hurt most rental markets, concludes Herb Chase, a managing director in the multifamily investment sales group with Los Angeles-based Colliers Seeley International.

While condo conversions benefit multifamily owners by shrinking the supply of apartments, condo buyers are typically renters, so conversions won't necessarily lead to a jump in occupancy rates. As Chase says, "It's a two-edged sword."

In fact, some conversions ultimately end up as rentals and compete with apartments, say both Chase and Linwood Thompson, managing director of Marcus & Millichap's national multifamily group. Speculators may buy condo units, intending to sell them at a higher price a short time later, for example.

But if the condo price fails to rise, the investor will try to find renters for the unit. "Depending on the market, 30%, 40% or 50% of condo buyers are speculators," Thompson says. "So that could be a problem down the road."

The propensity for condos to revert to rentals grows as the condo conversion trend matures, and residential experts have good reason to believe the latest condo boom is peaking. The interest on a 30-year, fixed-rate mortgage hovered between 5% and 6% over the last several years, helping to propel homeownership and the condo craze.

The more recent trend has been for mortgage rates to climb slowly but steadily. As of May 13, 30-year mortgage rates were 6.34%, or nearly 100 basis points higher than the 2004 low of 5.38% on March 18, according to Freddie Mac. Once interest rates hit 7.5% or 8%, experts say, condo conversions will cool.

"We've been busier than ever, and I think people realize that it's the last chance to buy at low interest rates," says Russell Galbut, a principal of Miami-based Crescent Heights, a condo developer and converter that has sold some 20,000 units valued at \$3 billion in major markets across the country. "[Rising interest rates] are not something that's going to have a chilling effect on the conversion business in the next few months, but eventually the activity is going to slow down."

The Strategy Behind Conversions

Converters typically search for apartment-to-condo conversions in desirable locations where they won't directly compete with affordable entry-level homes. Rather, converters want to offer an alternative to pricier single-family homes or to costlier condos in new developments nearby.

Developers figure out how much units will fetch and then determine how much they need to spend to improve the property and units. Upgrades are typically made to the property's exterior and common areas. Amenities such as granite counter tops and wood floors are often added to individual units, for example. The upgrades are built into the condo prices. Armed with that information, converters tabulate how much they can pay for a property and still generate desired returns.

Once converters acquire an apartment property, they generally convince about 10% to 15% of the existing renters to buy — usually at a discount to the price outside buyers will pay — before marketing the remaining condos. One key to selling condos is to convince buyers that they are better off owning versus renting, which is done by pointing out the benefits of the current low interest rates, the mortgage interest tax deduction and how property appreciation increases equity, says Robert Kaplan, managing director in Holliday Fenoglio Fowler's Miami office.

"You only need to look at the end-user financing to determine how feasible a project is, and the capital for residential is extremely liquid," says Kaplan. His office made \$650 million in loans to condo converters in Florida last year, up from \$200 million in 2001. "People don't want to rent, they want to own, and low interest rates have provided the opportunity."

Converters Pay a Hefty Premium

Fortunately for apartment owners, investor demand for multifamily product has remained strong even as prospective renters have purchased homes instead. The billions of dollars of debt and equity pouring into the apartment market enable sellers to fetch record prices for their projects: Nationally, capitalization rates are averaging 6.6%, according to Real Capital Analytics.

But capitalization rates mean nothing to converters because they aren't concerned with operating the apartments for a steady stream of income. Instead, their focus is on trying to maximize their returns by liquidating the units at the highest price possible. Converters are willing to pay a premium for properties over what conventional apartment investors are willing to spend — in some cases up to 40% more. That is providing an enticing exit strategy to apartment owners of all stripes — whether they're struggling to fill older Class-B properties or are operating new but stabilized Class-A properties.

Converters acknowledge that they are paying a premium, but are quick to add that the cost of acquiring and upgrading multifamily properties is far less expensive than new development. Plus, in densely populated urban markets, vacant ground simply doesn't exist for new development in prime locations, and converters anticipate those real estate values will continue to appreciate.

"The bottom line is that you can buy something for one-third of the cost that it would take to buy the vacant land and build something on it," says Crescent Height's Galbut. "As time goes on and the world wakes up, that apartment isn't going to be selling for one-third of what it would cost brand new, it's going to be selling for 60% to 80% of what it costs brand new."

Rates and Risk

Once cheap mortgages vanish, however, condo conversions will become riskier: home sales will slow, and converters may be unable to sell their condos. In a worst-case scenario, converters who pay a premium for struggling apartment projects will be forced to rent unsold condos in a project for which they paid too much — and in an apartment market that likely already is soft, says Nevid of Mountain Funding.

Converters downplay the risks. They contend that the affordability of conversions will become even more attractive to homebuyers in a rising interest-rate environment. Plus, longtime condo players say they never stopped turning apartments into condos, even when interest rates hovered around 17% to 18% in the early 1980s.

And even if slowing home sales force converters to rent their units, it's still less risky than embarking on new condo construction only to see the market crash, says Louis Birdman, a managing member of SunVest Resort Communities in Hollywood, Fla., who has converted more than 6,000 units in Florida since the 1980s.

"The downside risks in the conversion business are a lot less in our opinion because, unlike new development, we already have a physical building," says Birdman, who claims that he's had no problem selling condos in some 70 previous conversion projects. "We don't find that condos suffer from the same cycles as other businesses — people always need housing in one form or another."

Searing Sales in the Sunshine State

Nowhere is the conversion craze hotter than in Florida, which is enjoying an influx of young, educated workers and second-home buyers from South America and Europe along with the northern snow birds that routinely flock to the state in winter. Combined, the Miami/Dade, Broward/Palm and Tampa markets in that state represented 30% of the \$2.6 billion of apartment acquisitions targeted for conversion between early 2003 and early 2004 in the U.S., according to Real Capital Analytics. Northern Virginia (\$341 million), San Diego (\$175 million), Chicago (\$135 million) and Atlanta (\$99 million) followed.

The velocity of condo sales, particularly in Florida, gives converters confidence that plenty of time exists before the market will turn. In fact, Florida developers have yet to find the top of the market. While converters continue to pay higher prices for properties, home buyers continue to spend more for condos, says John Goldsworthy, director of marketing for Equity Marketing Services in Miami, a firm that has handled the sales and marketing of 130 condominium developments since 1980.

"I think apartment owners realize that we're nearing the top of the market right now and that it's the best time to sell," he says. "A lot of them are putting their properties on the market unpriced and are having a 15-to-20 day call for bids. And converters are snapping them up left and right."

Earlier this year, DK/Equity, a joint venture between Equity Marketing and Chicago-based Draper & Kramer, acquired the 7-year-old, 334-unit Floridian in Miami Beach for \$98 million. The \$293,500 price per unit is the highest ever paid in Florida. DK/Equity, which was backed financially by The Carlyle Group, LaSalle Bank and Boston Capital, made a further undisclosed investment to upgrade the Floridian's exterior, lobby and other areas of the 33-story building as part of the conversion process.

As of mid-May, the partnership had sold 180 condos in about 12 weeks, Goldsworthy says. Depending upon the upgrades buyers want in their condos, prices start at \$266,000 for a one-bedroom unit without a Biscayne Bay view to more than \$625,000 for a three-bedroom unit with a bay view.

On the other end of the affordability scale, SunVest earlier this year acquired the Fairways at Grand Harbor in Vero Beach for \$24 million, or \$93,000 a unit, with its joint venture partner, Hamilton Investment Group, a condo developer in Coral Gables, Fla., that has built 8,000 units in Puerto Rico and Florida.

The 257-unit gated Mediterranean-style community, which was built in the late 1990s, required little additional investment, says SunVest's Birdman. Condo prices range from \$90,000 to \$140,000, and only five months after its conversion, SunVest/Hamilton has sold all but 20 of the condos, he adds.

Diverse Buyer Pool

Condo buyers fall into all categories. Buyers of the Floridian condos are shelling out big bucks for a lifestyle upgrade, for example. But in San Diego, condos offer an affordable alternative to single-family home prices, which have climbed 25% to nearly \$480,000 over the past year, according to CB Richard Ellis. Potential homebuyers unable to pay those prices can purchase a condo for some \$300,000.

That kind of price discount has made San Diego ground zero for condo conversions in California. In 2003, developers converted some 3,000 apartment units to condos, nearly five times the 619 units converted in 2002, according to a report compiled by CB Richard Ellis and L.J. Melody. Developers will convert 4,000 units this year, says Gary London, president of the London Group in San Diego, a real estate strategy and analysis firm that focuses on Southern California.

"The phenomenon started with higher-quality units in the better neighborhoods, but now conversions are everywhere there is inventory — even down into the Class-B properties," says London. "Condo conversions are almost the last bastion of truly affordable housing in San Diego."

REITs Follow Suit

Traditional condo converters most closely resemble the value-add players in real estate: entrepreneurs who try to buy, improve and sell properties in a short time period to avoid operating them. But the condo conversion trend is so hot that it is enticing real estate investment trusts (REITs), which are scrutinized as much for their operating talents as their development abilities.

Executives at Atlanta-based Post Properties, for example, are considering converting properties within the company's portfolio into condos and developing new condo projects, says David Stockert, CEO of Post Properties. While the company is still just exploring the condo idea — one that it would likely undertake with a joint-venture partner — Stockert says the concept is appealing within submarkets where condos and apartments are the prevailing property type.


He identifies Atlanta's Midtown district, a commercial urban area that's attracting dwellers, as an ideal location for a conversion. Post operates two of its newer properties — the 188-unit Post Parkside and 276-unit Post Biltmore — in Midtown. The REIT also owns the luxury 121-unit, 20-story Post Peachtree in nearby Buckhead, which it built in 2001 with the possibility of someday converting it to condos.

"Midtown is becoming a real population center, and the only housing you're going to build there is multifamily or condo — if you want to live there you're not going to have a single-family option," he says. "In that kind of submarket, I think condos can make some sense."

Timing, much like location, is everything in real estate. Converters who fail to recognize the cycle's peak risk exposing themselves to financial disaster, especially as apartment owners keep upping the ante. In fact, some converters have spotted rotten deals just waiting to happen.

"There are properties in certain areas we looked at three or four years ago that we decided we didn't like priced at \$60,000 or \$70,000 a unit," says Birdman of SunVest. "Today, those same properties are \$120,000 a unit."

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