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RECENT CONVERT

THE CONDO CONVERSION CRAZE IS COMING BACK, BUT DEVELOPERS LIKE MICHAEL REYNOLDS ARE TAKING A SMARTER TACK

INSIDE:

GREEN WASH?
IS CERTIFICATION WORTH IT?

EMERGING 'HOOD
BREAKING INTO UP-AND-COMING AREAS

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Oakland, Calif., developer Michael Reynolds rents out all of his condos in their first years of existence, a strategy that kept him afloat during the recession.

Back to Life

The condo conversion landscape is littered with the ghosts of failed developers past. But smart companies are resuscitating this once-moribund market.

by linsey isaacs

WHEN MICHAEL REYNOLDS LOOKS BACK AT THE CONDOMINIUM SCENE in 2009, he's happy just to call himself a survivor.

The Oakland, Calif.–based developer started two local condo projects between 2006 and 2009, adding to a metro pipeline of 11 other deals under way during that time. Yet, only two of those 13 projects survived, and they both belong to his company, Embarcadero Pacific.

"[That] was without having the keys tossed back, or the equity totally wiped out by the lender," he says.

Taking a conservative financing approach certainly helped him weather the storm. But the true saving grace was Reynolds' patented strategy of leasing the units before selling them. It's a plan he follows regardless of whether the condo market is soaring or tanking, a road map honed over a quarter century with Embarcadero Pacific and Bond Street Advisors.

The Bond, a 101-unit boutique condo development in Oakland's Jack London Square, is a prime example of this strategy. When The Bond opened its doors in 2009, many local condo developers were leasing up their units, by necessity. But there was one big difference separating Reynolds from the pack: They hadn't planned on renting, and they paid a hefty price for that lack of foresight.

Armed with a five-year plan, The Bond had near full occupancy for three straight years under a low interest-rate scenario, creating great cash flow as Reynolds rode the rent escalation wave and waited. And today, The Bond is selling units at prices twice as high as what it could've commanded back in 2009.

Reynolds stayed ahead of the curve, ironically, by taking a back seat.

TIMING THE CONVERSION WINDOW

The for-sale market might have been slow to bloom over the past five years, but it's now ripe for new entrants. And many multifamily owners are looking at the strong demand for, and limited amount of, for-sale housing as a window of opportunity.

Paul Zeger, principal at San Francisco–based Polaris Pacific, is a 26-year veteran of the industry, and this is the third swing of conversions he's seen. But unlike previous cycles, today's market is dictated by a lot of pent-up inventory: Many purpose-built condos developed in the past six years have been biding their time as rentals and now need to be recapitalized.

Take the Universal Lofts in Studio City, Calif., for instance. The 67-unit live–work property, located across the freeway from Universal Studios, was completed in 2008 by Los Angeles–based Cahuenga Pass Development.

“The deal was built as condominiums,” says Shlomi Ronen, managing principal at Los Angeles–based real estate investment banking firm Dekel Capital. “The execution on the project was perfect, but the timing was terrible.”

Unable to find home buyers, the developers extended the construction loan and leased up the building, waiting for the recession to end. In September, Dekel Capital arranged $37.25 million worth of bridge and mezzanine debt, providing a three-year term that gives the developers some time to market and sell the units.

“The housing market has stabilized,” Ronen says. That’s especially true given the lack of new for-sale assets in the pipeline right now—at least in California. San Francisco in particular will see about 8,000 housing units delivered through 2015, Zeger says. Yet only a fraction of those units, about 500, are condos.

In South Florida—a region mired in excess inventory throughout the recession—some 173 condo towers have been proposed since the third quarter of 2011, and about 20,000 units are currently on the market as resales, according to market research firm Condo Ratings Agency.

“The market is simply so strong,” says Peter Zalewski, principal at Miami-based research firm Condo Vultures. “Especially for those who are looking to capitalize on the rental side.”

Back in Oakland, Reynolds sees no competitive for-sale offerings in the region now, leaving The Bond with a cornerstone on the market. And, as far as he can tell, no newly built product is coming to the East Bay market anytime soon.

AN EXIT STRATEGY, OR TWO

For Reynolds, being patient is about more than just timing a market cycle. It’s an all-encompassing approach to ensure success.

In fact, timing a market cycle doesn’t even come into play. Whether it opens a building in a robust or rotten for-sale environment, Embarcadero Pacific’s buildings always hit the ground running as rentals.

“We’ve had buildings we’ve opened up in a robust for-sale market and have continued to lease,” Reynolds says. “It’s difficult to underwrite new construction as a rental today and hold for a condo exit. It’s a conservative strategy, but it keeps us as a player in the Bay Area market.”

Sometimes, Embarcadero Pacific rents out a building’s units for as little as two years, and sometimes for as many as four. So, while other condo developers rent only when they have to, Reynolds rents because he wants to.

“We approach each investment with an eye toward two ways out,” he says. “We underwrite, finance, and capitalize our projects based upon a stable pro forma rental income.”

Reynolds structures his capital stack as though he’s building luxury rentals. Many condo buildings that go straight into the sales market require a healthy mix of equity, debt, and mezzanine capital. But Reynolds only uses traditional bank debt and private capital. One of the upshots is a lower required level of interest reserves from the construction lender.

“You can substantially lease up the building in five to eight months, rather than carrying enormous interest reserves for the perceived absorption of condominium sales,” he says. “Your loan value then goes down as your interest reserve component falls.”

That approach also decreases insurance costs: In California, the developer can delay buying an owner-controlled insurance program until it begins selling the units. And the strategy yields real brick-and-mortar benefits; namely, in mitigating physical risks, such as the possibility of building defects.

“That’s a risk that the developer takes—is the customer saying, ‘You didn’t do a good enough job, and you have to go back and fix it. You owe us money,’ ” Zeger says.

So, Reynolds’ plan isn’t just about financial engineering—it’s also an opportunity to give the building a test drive and iron out any kinks before selling a single unit.

“When the first storms come in, you find out where the leaks are,” Reynolds says. “Or when the first mechanical issue comes up, you find out what’s going on and you correct it.”

Other benefits of his five-year plan include getting a better handle on operation costs. Ultimately, though, it’s all about having control over your own future.

“It’s the best strategy for private capital; it’s not the best for institutional,” Reynolds says. “We can call our exit. We can time our market exit better than a forced out-of-the-gate sale as condominiums to

The Bond: Patrik Argast; Universal Lofts: Shlomi Ronen

The Bond (opposite, far left) is full of stylish amenities, making the conversion from a luxury rental to a condominium seamless in today's market. Similarly, the developers behind Universal Lofts (near left) in Studio City, Calif., leased each unit to weather the financial storm in '08, bouncing back today with condominium sales to take advantage of a steaming West Coast market.

pay back an institutional partner or even a highly leveraged mezzanine debt situation."

THE CONVERSION PROCESS

The conversion trend has yet to take the market by storm, but all signs point to its inevitability.

"[Is it happening] today? No," Zalewski says. "Is it coming? Yes."

Zalewski sees workforce housing—aimed at the middle class—as the first candidate for condominium conversions in South Florida, since such units require limited expenditures for maintenance and amenities. And some owners are still capitalizing on today's high rents and are waiting for a healthier for-sale market to develop in 2014, or 2015.

South Florida is used to this, though. The market peaked in 2005, came back in 2011, and it wasn't until last year that investors really started piling on. The region is now more than two years into its recovery, and developers should probably strike while the iron is hot.

"That's why I suggest now [is] better than later," Zalewski says. "The market's going to already pass."

Ronen also suggests that the limited amount of new for-sale product on the market means condo converters have a unique window of opportunity now.

"So to the extent that someone wants something new, it almost has to be a condominium," he says. "The projects that have already been built as condo are perfect because they've already been built to the spec."

Now, plenty of communities being built will have a condominium map on them so that developers have the option to eventually turn the building into a condo. But some might be a little too late.

Developers would have had to start on new product two years ago to deliver to a hot market today. And developers sitting on land are at least two to three years away from delivering condos, and the economic period is likely to adjust.

So, what does it take to get started on the conversion process?

By obtaining a final public report on the property issued by the state, developers can determine if they're allowed to sell and close their multifamily building as a condominium. The process varies from state to state, but for Reynolds, in California, it can take about three to six months.

The next step is giving the tenant the notice to sell, and a right of first refusal to occupy and own the unit upon conversion. The 90-day agreement includes terms of the offering. It saves owners on marketing costs when they can successfully transition tenants to buyers. But this usually only applies to a small amount of residents, maybe 5 percent to 10 percent.

"Typically, renters are renters," Zeger says. "That's either their mind-set or what's economically viable for them."

It's important to map out the construction process and record a condo plan with notice of completion. By purposefully building for condos—with their higher-end finishes and acoustic considerations—Reynolds is assuring a certain type of quality control.

Buying an existing rental building for conversion is much riskier. A buyer could find that an architect or builder might have cut corners. Those become conversion downfalls, primarily on stick-frame buildings, Reynolds says. When conversions were big, plenty of stick frames that were sold landed developers in court.

"You smelled your neighbors' cooking, your windows leaked, your roof leaked," Reynolds says.

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> —Michael Reynolds, Embarcadero Pacific

BATTLE TESTED

The condo conversion business can be a dangerous game. But with a lot of up-front planning and a conservative approach, the upside can be tremendous.

You have to work with builders who understand the strategy. Construction contracts need to be crafted so that the warranty switches the minute the building converts to condos.

"It takes a firm with a good reputation and someone who's done it before," Reynolds says. "Your contractor and subs and lender need to buy into it. It's really technical."

The move is also labor intensive, as mapping out the condos requires getting entitlements while construction occurs. The process can get a little complex. But by renting for a few years, Reynolds ensures the final product is ready for prime time.

"You're selling a reputation; you're selling good product," he says. "The consumer knows it's been tested for three years." MFE