Ghost Towers: Distressed Condominium Investing in Atlanta

By

Faraji L Whalen

B.A. Business Administration

Morehouse College, 2001

Submitted to the Center for Real Estate in Partial Fulfillment for the Degree of Master of Science in Real Estate Development

At the

Massachusetts Institute of Technology

September, 2009

©2009 Faraji L Whalen
All Rights Reserved

The author hereby grants to MIT permission to reproduce
and to distribute publicly paper and electronic
copies of this thesis document in whole or in part
in any medium now known or hereafter created.

Signature of Author:____
Faraji Whalen
Center for Real Estate
July 24, 2009

Certified by:____
Lynn Fisher
Associate Professor of Real Estate
Thesis Supervisor

Accepted by:____
Brian A. Ciochetti
Chairman, Interdepartmental Degree Program in Real Estate Development

Ghost Towers: Distressed Condominium Investing in Atlanta
By

Faraji L. Whalen

Submitted to the Center for Real Estate
on July 24, 2009 in Partial Fulfillment of the
Requirements for the Degree of Master of Science in
Real Estate Development

ABSTRACT:

The purpose of this paper is to explore investment opportunities in these now-distressed residential condo properties. The paper will characterize the economic and development environment to determine the extent of overbuilding and forecast future behavior amongst market participants. It will assess the behavior of bulk condo investors in previous downturns to assess both similarities and differences in the environment, and identify best practices in investment and asset management. Additionally, the paper will characterize the legal and management risks inherent in this type of investment.

The paper will conclude that there are a number of different strategies for investing in bulk condos and their underlying debt. One of the hardest hit markets is Atlanta, Georgia, which is the focus of this paper. Each of these strategies is contingent on the type and expertise level of the individual investor, but there are certainly going to be appropriate avenues for investors to create value both from the physical asset and from purchasing debt. Atlanta is likely going to be an excellent market to pursue these deals because of unique localized factors including extraordinary state distress, low asset pricing, and limited competition. The findings in this paper conclude that distressed condominium investing is an extremely localized business, and the recommendations made in this paper are specific to Atlanta. While an investor may use the paper as a guide for investment in other locales, it would not be appropriate to use a cookie cutter approach in every city. There are also many risks and a great deal of unknowns in the bulk condo space. This downturn differs significantly from past real estate crises because of the complexity of the financial instruments used to fund condo projects as well as a completely different government response. It is clear that the government response up to this point has been as much of a hindrance as it has been a help. Government action must engage investors in financial instruments in a more predictable manner, and assure they will not engage in punitive legislative behavior to investors who profit from this crisis.

Thesis Supervisor: Lynn Fisher
Title: Professor of Real Estate

Acknowledgments

I would like to acknowledge the efforts of Dr. Lynn Fisher, for guiding me through the thesis process as an advisor and mentor, and pushing me to stretch myself. I would like to thank the industry participants who provided critical insight into the topic. I would also like to thank Messieurs Cailao, Tilford, and Solorzano for their solidarity in burning the midnight oil.

Chapter 1: Introduction……………………………………………………………...………….5
- Purpose of Thesis………………………………………………………...…………..5
- Research methodology…………………………………………………...……..8

Chapter 2: History Review…………………………………………………...……...10
- The S&L Crisis………....…………………………………..………......…10
- A Comparison of downturns...11

Chapter 3: Market Data……………………………………………………...……...…17
- Building the Bubble: A brief history of contributing factors…...…….............................…17
- Submission of market data and extrapolation of key data points…...……........................…19
- Qualitative analysis of findings…...……..…20

Chapter 4: Market Participants…...…..…...…33
- Developers…...…..…...............................…33
- Construction Lenders…...…...…................…34
- Investors…...…...…...................................…35
- Regulatory Agencies…...…..…...................…35
- Mortgage Lenders…...…..…...................…....38
- Government Sponsored Entities (Secondary Mortgage Market) ...….....................................39

Chapter 5: Analysis of Survey and interview data and feasibility Analysis..........................42
- Characterization of opportunity...…...42
- Major obstacles...…...42

Chapter 6: Strategies...…...49
Chapter 7: Strategies...…...53
Works Cited...…...55

CHAPTER 1: INTRODUCTION

PURPOSE OF THE THESIS:

As of the time of this writing, the residential real estate market is undergoing significant price depreciation coupled with oversupply. Nowhere is this more apparent than in the condominium market. The dramatic price appreciation that began in 2003 and ended in 2007 encouraged developer and buyer behavior that was significantly outside of historical norms.

Construction of condominium units in the US almost quadrupled from 40,000 starts in 1993 to 150,000 starts at its peak in 2006, accounting for 45% of all multifamily starts nationwide, a vast change from the period between 1991-2003, where for-sale residential starts typically accounted for 25% of multifamily starts (US Census Bureau, 2008).

For developers whose projects hit the market before 2006, this was an extremely lucrative business. Easy credit and the promise of double digit annual price appreciation in many markets resulted in many projects selling out before construction was even complete, often at prices much higher than developers anticipated. Buyers benefited as well, as many investors flooded the market, and "flipped" their units, or even their contracts to other buyers at a profit. The sheer profitability of this business further encouraged construction of more condo projects.

The bursting of the real estate bubble in 2007 eroded buyer enthusiasm, but almost no one was prepared for the global financial meltdown of 2008, which paralyzed credit markets, destroyed trillions of dollars of wealth, and effectively demolished the market for condominium buyers, paralyzing both their willingness and ability to purchase. The end result of these dramatic swings in behavior by market participants is the situation we now find ourselves in: A dramatic oversupply of residential condominium units with buyers unable or willing to pull the trigger in present market conditions.

As of the first quarter of 2009, the Atlanta MSA had 6,032 unsold developer sponsored units. Only 645 developer-sponsored condos sold in 2008, with only 66 trading in the second half of

the year. The Buckhead submarket has been particularly hard hit, with only 103 units sold in 2008, compared with an annual sales rate of 1,066 for 2005-2007. ((Haddow & Co., 2009))

Atlanta is the new Miami.

At least that is the claim of a January 2009 Wall Street Journal Article describing the extent of the carnage in the Atlanta condo market. I selected Atlanta as a target market for a number of reasons:

- Atlanta is currently suffering severe distress particularly in the condo market. That said, I believe the 2008 sales figures to be an anomaly, and I will indicate how those statistics are not as dire as they sound. As the de facto business capital of the South, Atlanta's economy is also fundamentally much stronger than Miami's, and is a net population gainer, particularly the young, educated cohort for whom an urban condo is an attractive housing choice.
- Atlanta is right-sized for investors. Unlike New York, Washington DC, and San Francisco, Atlanta's distressed market will fly beneath the radar of many large institutional and international investors. Additionally, Atlanta condominium product even at its height was significantly less expensive per square foot than comparable product in most other major cities, particularly in the Northeast and West Coasts. This presents an opportunity for more investors to join the party.
- The distress is fairly focused. A disproportionate share of Atlanta's condo inventory was financed by a small number of lenders, many with whole loans. There has already been a significant number of bank failures in Georgia, many of those initiated by the souring of real-estate backed loans. Additionally, Atlanta suffered a disproportionate amount of both investor activity and mortgage fraud during the boom, making some projects and areas impossible to finance through traditional methods. Investors may find themselves the last resort for many holders of distressed assets. I hypothesize this will provide investors more and better opportunities to find assets at substantially discounted prices compared to other markets.

The motivation for this thesis is that market disruption creates opportunities for new participants to benefit. I hypothesize that end users are unwilling or unable to purchase existing inventory, a new capitalized entity will be able to take advantage of the distress of the current owners of this

real property and purchase these assets at a steep discount to market price and perhaps even at a discount to replacement cost, in order to execute a profitable exit strategy.

The paper will characterize both the opportunities of this investment strategy, as well as the risks and challenges, which are many. The paper explores the historical context of bulk condo investment, particularly the period between 1994 and 1997 when much of the excess inventory from the downturn of 1991 was absorbed by investors. By comparing and contrasting the economic indicators, housing prices, and financial environment of these two periods, the paper will forecast the efficacy and likelihood of bulk condo deals occurring en masse, as well as establish best practices in this meme of investing. The paper will characterize the investment requirements and attitudes of investors as well as the challenges facing lenders and developers holding these wasting assets, and explore both parties' willingness and ability to complete transfers of real property at prices and terms amenable to both.

The traditional definition of bulk condominium investing is the purchase of multiple units of a condominium project by an investor either to convert to rentals or resell at a higher price creating a spread via cash flow, exit price, or both. As this paper will explore, there are a number of alternatives to this direct purchase strategy, with different advantages as well as risks. This paper will discuss the following entry types:

- Purchasing construction debt backed by a condo project.
- Recapitalizing distressed developers.
- Purchasing foreclosed condo projects in whole.
- Purchasing incomplete projects.
- Purchasing Banks with high exposure to Condo-backed loans. [1]

The paper will also explore the differing exit strategies investors may use to create value from a distressed condo project. These include:

- Conversion to rentals

[1] As of the time of this writing, Starwood Capital is rumored to be purchasing Corus Bankshares. Construction loans accounted for 88% of Corus's outstanding loans at the end of the first quarter. (Wei, 2009)

- Resale to individuals
- Apartment/Resale Option
- Repurpose
- Reselling Debt

The thesis will benefit investors, who seek guidance on how to profitably invest in bulk condominium units, as well as lenders and developers who need to divest these assets. While capital has been organized to take advantage of exactly these type of deals, at the time of this writing, few deals have actually closed. This paper will characterize the legal, economic, regulatory, and management challenges which make these investments so risky, and recommend solutions to end what has become a de facto three way standoff between developers, lenders, and potential investors.

The following describes the research methodology utilized for this paper: Chapter 2 will focus on the most recent major downturn in the US real estate markets, the Savings and Loan Crisis of the late 1980's and early 1990's. The chapter will explore investor behavior during that period and analyze what similarities exist in the economic, regulatory, and real estate character of that period with the current downturn, in order to determine what lessons investors may learn. Chapter 3 will provide an assessment of the scope of the problem and the opportunity in Atlanta . The chapter will characterize the nature of the Atlanta market and analyze both the scope of overbuilding how this will affect a recovery. The chapter will also characterize which submarkets have the most extreme distress and what divestiture and investment activities have occurred up to this point and forecast what activities are likely to occur in the near future. Chapter 4 will interpret interviews with lenders, developers, and investors to qualitatively characterize the investment community's attitude and likely course of action. Chapter 5 will focus on the feasibility and timing of bulk condo investing. Looking at data from the most recent downturn, investors did not rally back into for-sale multi-family for years after a price bottom was reached. This chapter will explore what parallels exist and the most likely scenarios for successful investing, as well as potential pitfalls. Chapter 5 will focus on the obstacles to this niche of investing. My research has indicated that condo investing has the potential to be one of the riskier and more complicated asset classes, and it is incumbent that investors understand the

pitfalls which may occur. Chapter 6 will detail the findings of this thesis and make recommendations for bulk condo investing.

Chapter 2: History Review

We've seen this before…Or have we?

In order to characterize any opportunities for investment, it is important to explore similar economic periods and examine the behavior of market participants to ascertain if there are parallels that can be exploited. I felt it was also important to look at the topic from the standpoint of investors to determine past behavior in terms of distressed asset investing.

The most similar real estate downturn in the United States to the current one appears to be the 1991 crash in commercial and residential real estate. The crash is widely credited to a similar set of circumstances as we find ourselves in today:

- **Overly aggressive lending practices** by financial institutions creating a mass of nonperforming loans. The financial and real estate downturn of 1989-1991 rendered many of these loans non-performing.
- **Deregulation encouraging institutions to take more risk.** In 1982, Congress permitted S&L's to make real estate loans without regard to the geographical location of the loan, and authorized them to hold up to 40 percent of their assets as commercial real estate loans.
- **Financial Innovation:** The Federal Home Loan Bank Board (FHLBB), the now-defunct regulator of S&Ls, authorized accounting gimmicks that violated generally accepted accounting principles and led to insufficient capital reserves. These had a similar effect to the "off-balance sheet" Special Purpose Vehicles that hid liabilities in today's downturn.
- **Ineffectual Government response:** An unwillingness to confront the true size of the S&L mess and anger politically influential S&Ls prevented appropriate action from being taken once the S&L problem was identified. (Ely, 2008)

The financial institutions that caused the crisis at the time were Savings and Loan institutions (S&L) which typically held whole loans. In response to the huge bank failures that occurred, The Resolution Trust Corporation (RTC) was formed. The RTC was a United States Government-owned asset management company charged with liquidating assets (primarily real estate-related assets, including mortgage loans) held by S&L's declared insolvent by the Office of Thrift Supervision, as a consequence of the savings and loan crisis of the 1980s. Between 1989 and

mid-1995, the Resolution Trust Corporation closed or otherwise resolved 747 thrifts with total assets of $394 billion. (Cassell, 2003)

One striking similarity between the two periods is the lack of actionable intelligence in the market and the apparent paralysis that occurred as lenders and investors both played the waiting game to engage one another in bulk condominium transactions. This occurred in the early 90's:

"*According to Yoron Cohen, managing director of Edward S. Gordon Company, there was not much activity in this segment from 1987 onward. During this time, foreign investors had a hard time identifying assets that were safe*." (Weiss, 1994)

The same rings true in today's market. A recent round table panel of industry professionals and potential distressed asset investors in Atlanta uncovered the following anecdote:

"Investors interested in assets held by banks that have gone out of business should be cautious, Greg Winchester, managing Director of Trimont Real Estate Advisors told the crowded room at the Grand Hyatt in Buckhead. "It's buyer beware and do a lot of asking around about the real estate," he said. TriMont has bid on assets from failed banks, including Integrity Bank in Georgia. In some cases, the FDIC did not divulge all important information about the portfolio and in other cases, the loans weren't administered well. "Essentially, you're on a scavenger hunt," Winchester said." (Wilbert, 2009)

There are two major differences between the two respective downturns; the first being that the vast majority of distressed paper in the S&L downturn was composed of whole loans. Securitization in the form of Commercial Mortgage Backed Securities (CMBS) and Colateralized Debt Obligations (CDO's) as a method for financing risky assets without consistent cash flows is a very new phenomenon.

The other major difference between the downturns is the federal response. The RTC was set up specifically to take over and dispose of distressed physical assets as well as paper the S&L's had accumulated through a variety of different methods, including equity partnerships with investors.

The federal government's current response has been to recapitalize banks and attempt to provide favorable financing terms to potential investors, a much more passive role.

Through my conversations with investors detailed in Chapter 5 and the previous literature review, I hypothesize that absent further government intervention, it will likely take longer for many assets to trade as the government has effectively guaranteed "too big to fail" lenders against insolvency and allowed others to shore up their balance sheet using "mark to model" accounting tricks. Additionally, those assets that have multiple levels of capital and debt in the capital stack with different owners will be very difficult to disentangle. It will take time to find out who the actual owner of each slice of debt is, and even more time for multiple parties, often with misaligned incentives, to come to agreement as to who the final decision maker is in any resolution.

One investor who is analyzing a potential deal described the difficulty in dealing with so many parties: "The first position wants to foreclose so they can redeploy capital. They want out. The bottom traunch wants to stick it out for a hope certificate. The special servicer is paralyzed because they know whatever they do, they're going to get sued, and frankly they're just inundated. There are no established rules to the game, so it's very difficult to figure out who actually has the legal authority to make a call." (Anonymous, 2009)

This difference in government reaction cannot be overemphasized in terms of investor strategy. In the S&L period, the government effectively worked with lenders to dispose of distressed assets. The Treasury and FDIC's efforts have been focused on maintaining the solvency of lenders this time however, a position diametrically opposed to an investor's desire to purchase assets at a significant discount. Investors' reaction to federal involvement has ranged from lukewarm at best to outright hostile at worst.

One investor at a large PE firm which was awarded a contract to work with the government on the PPIP described the program as *"Exactly something our firm would like to invest in. Obviously, since we're going to be part of the program, we see it as potentially a very profitable idea. It's just that right now, not a lot of deals have materialized."* (Anonymous, 2009)

This investor was in the minority, however. The vast majority of investors I interviewed had much more in common with the sentiment of the Vice President of a small real estate private equity firm:

"We're scared to death about getting involved with any of the (government) programs. We've looked at them, and frankly, the rules of the game keep changing. There's no way you can underwrite that." (Anonymous, 2009)

The difference may also manifest itself in how quickly (or if) the economy as a whole returns to a period of growth. There is a fear that because lenders are not being forced to dispose of toxic assets quickly, they will continue to weigh down financial institutions' balance sheets, curtailing lending and economic growth as a result. This will continue to impede the mortgage market, and make a successful exit from condo assets much more difficult.

"The most likely outcome here is that instead of blowing out assets, some smaller banks will be closed, and the FDIC will force the survivors to dribble out assets over time so they remain solvent. We will have our lost decade." (Anonymous, 2009)

If one buys this particular outlook, then an investor will have to make underwriting assumptions for purchasing assets more in line with Japan's economy in the 1990's than the US rebound of the same period. Investors will have to assume low or even negative growth in both condo prices and rental rates, low additional supply coming to market, and a lengthy investment period before the asset can be disposed of at favorable prices. As it is far from certain what a recovery will look like, individual investors will have to price assets with a great deal of uncertainty. Bullish investors who foresee a quick recovery will outbid those who believe we face a "lost decade." From a competitive bidding standpoint, this favors investors who are not tied to institutional capital and who are willing to take higher risks. Even among the investors I interviewed who managed "vulture" or "opportunity" funds, all described their organizations as "risk-averse." Additionally, most managed closed-ended funds with a closing date of five to seven years, and would not be willing to tie up capital if the prospectus suggested that the investment period

would extend beyond that. A similarly capitalized high net worth individual or group without these limitations would be at an advantage in bidding for these assets.

In the Atlanta market specifically, there was significant distress during the S&L period. The RTC headquartered offices in Atlanta to handle the resolution and disposition of $90 billion worth of mortgages, other loans, securities and foreclosed real estate, beginning in 1989. At its peak in November 1994, the RTC's Atlanta office employed 1,100 workers, who handled the agency's takeover of 140 ailing savings banks in the Southeast, Puerto Rico, the Virgin Islands and Washington. Only 16 of those banks were in Georgia, with five in Atlanta. (Atlanta Business Chronicle, 2008) At the time of this writing, 15 Georgia banks have been failed, all of them carrying outsize loads of real estate. The state is home to just 4% of all U.S. banks, but 20% of the nation's bank failures. As many as 30 banks in the state are at risk of failure, leading Tom Fineman, the head of the Independent Community Bankers of America to remark, *"Georgia is basically the Chernobyl of banking right now; it's radioactive down there,"(Paletta, 2009)*

Despite these and other challenges, investors of many different types were able to take advantage of the distress of the S&L period to make money. The primary method for acquiring these assets were auctions conducted by the Resolution Trust Corporation (RTC). Potential bidders would attend due diligence informational meetings and then submit sealed bids for the target asset. The RTC primarily used variants of English Auction and first-price sealed bid auctions. (Nanda, 1997)

The Cadle Co., a private investment firm in Newton Falls, Ohio, has been buying nonperforming loans from the RTC since 1990 and was the winning bidder on a $1 million package of delinquent commercial mortgages at an auction in Los Angeles this past September. The company pays an average of 25 cents on the dollar for its loans, says President Daniel C. Cadle. His staff of 30 spends most of its time trying to restructure the debt so that the borrower can resume payments. Failing that, the company forecloses on the properties and sells them. Cadle says he loses money on some assets, doubles his money on others, and averages a 20% return. (Fefer, 1992)

Paul Miller, a San Diego attorney has purchased $1 million in Southern California mortgages at previous RTC auctions for about 55 cents on the dollar, he said. Unlike debt purchased from other financial instructions, RTC auctions don't carry any warrants or guarantees that the loan documentations is accurate, said Scott Hahn, director of data processing at San Diego-based West Capital Financial Services. Even many larger investor groups say they stay away from RTC auctions. But Ziskin said several of his bank clients in San Diego, whom he declined to identify, have taken part in previous auctions. All of them "have gotten very significant returns," he said. "Nobody's looked back and said they said they wish they hadn't done it. Al Severson, president of Grossmont Bank, the largest locally headquartered bank, said his institution is not among them. "There may be some bargains out there," he said. But, he added, Grossmont would rather spend its time on high-quality assets than on "cleaning up other people's mistakes."" (Entrepreneur, 1994)

The split between Miller and Ziskin and Grossmont echoes the sentiment I received from my interviews. While many investors are actively looking at condo deals, all admit that they consider them high risk. Given the litany of other core distressed assets investment opportunities that will likely become available, I hypothesize that small and entrepreneurial investors will be able to successfully bid on condo assets. I further hypothesize that as the CMBS maturities backed by commercial office and residential rental properties come due, many of these funds will focus on those more conservative assets, leaving condo deals to smaller players.

While it may appear that a new version of the RTC would be a more efficient way to dispose of the distressed assets on many banks' book, the experience of the RTC proves somewhat more muddled:

A February 1992 Chronicle story reported how the RTC was selling off properties in Atlanta at below appraised value. "About 86.3 percent of 600 deals struck to unload houses, condominium units, undeveloped land, apartment complexes, industrial parks and other properties have fetched less than the RTC's appraised value," the story reported. "If they sell too quickly and too early, they're all unemployed. The RTC personnel delay and frustrate legitimate purchases, so that the

prices they finally accept are often only a fraction of previous offers."[2] (Atlanta Business Chronicle, 1992)

The timing of investments during the RTC days does give some clue as to when investors can expect will be an appropriate entry point in the market. During the late 1980's and early 1990's, distressed asset deals were common throughout the period, but it took until 1994 before a critical mass of bulk condo deals became available. This reflected both investor unease with market information as well as the reticence of healthy banks to dispose of assets. During this downturn, a similar story is developing. Unlike the aftermath of the S&L scandal, however, there is not an RTC to facilitate the disposal of toxic assets. While the PPIP program is intended to encourage participation, the government has not as of yet forced these transactions to occur. My review of historical literature and interviews with investors suggests that there is capital available right now, and investors are simply waiting for lenders to capitulate. I believe deals will start happening en masse within the next six to twelve months in the Atlanta market because of the bank failures and the frozen sales market, but this may take significantly longer in other markets. Investors who deployed capital late last year assuming the markets had hit bottom have already taken losses on their investments, and they have already emerged as "first losers." Investors interested in pursuing distressed condo buys should be lining up capital and sourcing deals now with the expectation of investment closings in the fourth quarter of 2009 through mid-2010. After that, deals will continue to be available, but likely at higher prices as investor confidence resumes.

So far in this cycle, it has not been the federal agencies that have been hampering the process, but rather the lenders themselves. This further supports my belief that small and local players who have relationships with the lenders holding the paper and the persistence to chase these deals will be at an advantage in being able to work through the numerous hurdles.

---

[2] This may seem like a boon to potential investors, but put in the context of today's highly politicized environment, any appearance of impropriety could be devastating for an investor.

Chapter 3: Market Data

The Condo boom

Most economists agree that the real estate "boom" first began to form in 2002. The consensus is that the tracks for the real estate bubble were laid primarily by federal monetary policy, particularly the Federal Reserve's decision to reduce interest rates. Beginning in 2003, the fed reduced the intended funds rate from 6.5% on May 16, 2003 to a 45 year low of 1% on June 25, 2003. This was a reaction to the burst of the tech bubble and the general downturn in equities in an attempt to avoid a more severe downturn and panic in the financial system (Belkse, 2005). As a result of the historically low funds rate, real estate values across commercial classes began to rise as reduced interest rates lowered the discount rates on future cash flows, making asset investments more profitable. Increased liquidity led to investment portfolio shifts from equities to real estate. Ironically, by creating so much liquidity, the Federal Reserve unintentionally set the stage for a much more severe downturn later in the decade. While the loosening of the money supply certainly was not the only cause of the real estate boom and subsequent bust, it is hard to argue that in effect, making money so cheap wasn't akin to putting a Desert Eagle in the hands of a suicidal manic-depressive, and the lending community in Atlanta showed early signs of drinking the real estate Kool-Aid:

Concerned about the pace of commercial and residential building in the Atlanta area, the Federal Deposit Insurance Corp. is urging community banks there to consider easing up on construction and development lending. Though banks in other rapidly expanding markets face similar risks, the FDIC singled out Atlanta because its community banks have the nation's highest construction and development exposures. The average community bank in the metropolitan area had 15.5% of its assets in construction and development loans in the fourth quarter, nearly three times more than for banks in other regions. Thirty-nine banks there with less than $1 billion of assets had ratios above 15%, and many were well above 20%. Such exposure could pose significant credit risks for these banks in a slowing economy, the FDIC warned in its semiannual Regional Outlook, released last week. The Atlanta area is facing "the most challenging environment in nearly a decade as key economic sectors weaken while competition in the banking industry remains strong," the report said. However, Atlanta-area

bankers said the FDIC is overreacting. Few seemed worried that developers would stop building houses, regardless of economic conditions. "It's not a surprise to anyone that there is some concentration of real estate development and construction," said Joe Brannen, president and chief executive officer of the Georgia Bankers Association. "The market has added a million people in population, and anyone not in construction lending is missing an opportunity. "Bank of North Georgia has about 30% of its assets in construction and development lending, but Don Howard, president of the Alpharetta bank, said he does not consider this risky. The $833 million-asset bank's risk is spread out because it lends to a number of developers who build homes in 16 counties, he said. "We haven't lost our enthusiasm for C&D lending," Mr. Howard said. "Our people have been through the good times and the bad, and we feel comfortable about where we are at." (Thompson, 2001)

The preceding article was written in 2001. Bank of North Georgia auctioned some $100 million of problem loans to private investors in June, 2009. Within the last year, the bank's non-accrual loans have increased 51 percent to $316 million, and the amount of foreclosed real estate increased 29 percent from $24 million at the end of first-quarter 2008 to $31 million on March 31, 2009. (Rauch, 2009)

The article illustrates the faith Georgia lenders maintained in the power of Atlanta's stellar growth rate to maintain or increase prices forever. In the early part of the decade, this faith was borne out, with fairly steady sales velocity and inventory. However, 2005 saw a spike in deliveries, followed by a gradual drop in sales, which then cratered in 2008. As an anomaly of a year, the extreme shocks of 2008 (Lehman and Bear Stearns folding, credit markets seizing, Dow Jones losses) may be the easy culprits in analyzing why sales velocity was so anemic. But even discounting the financial crisis that gripped the country after the Bear Stearns collapse, only 579 new units were sold in the first half of that year, less than half the previous year's first half sales and a full quarter of the 2005 peak. (See Chart 3.1)

Chart 3.1

Year	1st half	2nd half	Total
2000	1966	1072	3038
2001	1440	758	2198
2002	1069	1075	2144
2003	1053	1133	2186

2004	1133	1606	2739
2005	2456	2291	4747
2006	1590	1027	2617
2007	1212	492	1704
2008	579	66	645

Source, Haddow & Co., 2009

Two distinct theories can help explain behavior on both the supply and demand side which led to the smorgasbord of overbuilding in the mid 2000's. On the demand side, I believe Robert Shiller's theory of "Irrational Exuberance" surmises why buyers and small investors displayed such a strong appetite for condos despite clear warning signs that the party would likely end badly. From a supply side, I believe a false interpretation of the Superstar City theory established by Gyourko et al. convinced lenders, who by nature are supposed to act as a sober counterbalance to the eternal optimism of developers, to fund projects which are now extremely troubled.

Irrational Exuberance

Shiller's theory on the creation of bubble markets separates statistical factors such as supply and demand from psychological "herd mentality" in explaining rapid price appreciation. By all accounts, Atlanta had little reason to add as many condo units as developers built. While the city was adding a substantial number of in-migrants every year, Atlanta has very few building constraints. It is a landlocked city, and sprawl into the suburbs has left the inner core relatively sparsely developed. Even in the downtown and midtown CBD areas, there are vast developable tracts of land used as parking lots or low density housing that could be easily redeveloped. There was little reason for anyone familiar with the basics of supply and demand economics to believe that substitutable condos would not eventually come online. Nevertheless, absorption of relatively undifferentiated condos was extremely strong until 2006.

As real estate professionals, the potential for competing product would give us significant pause in investing in such an area. However, it is my opinion that for laypeople, the fact that prices had been rising was a good enough reason to purchase a condo as an investment. If anything, the addition of new supply may have convinced people that the market was deeper than it was, particularly when the new supply was offered at higher prices than existing stock. In emerging

markets such as downtown and tertiary areas of midtown, the arrival of new supply also suggested that gentrification was occurring en masse, and neighborhoods that were previously "cheap" would appreciate to similar values as core neighborhoods. From 1992-1999, Dowtown added just 545 new condo units and conversions. From 2000-2008, that number was 3,276. In the Intown non-core area, there was not a single condo unit added to the market before 1999. Since then, 8,794 units have been added. (See Appendix 1) Entirely new neighborhoods have effectively been created. Additionally, I hypothesize many investors felt that Atlanta was underpriced and speculated that prices would skyrocket as they did in places like New York, Washington DC, and San Francisco. One local real estate agent who specializes in bank-owned and pre-foreclosure condos described the mindset:

"Atlantans have this perpetual inferiority complex. I don't know if it's from the people who come here from other places or the locals who are still mad that they lost the civil war, but there's this sense here that the city's always being looked down upon by the Manhattans, the DC's, the Chicago's, and so people desperately wanted to have something that says to their friends in New York, oh, your condo went up 15%, well mine went up 20%. And that was the promise a lot of people were buying into. So you have all these buildings that look like they belong in New York or Chicago, and people wanted them to appreciate like those cities. It just didn't happen."
(Anonymous, 2009)

From a pricing perspective, the agent was correct. While new supply came on the market, average prices remained much more stable than in the Northeast or West coast through 2007.

Chart 3.2

Year	Avg. Sales Price	YOY % increase	New Condo Deliveries	Units under Construction
2001	$215,725		2818	1830
2002	$227,096	5.27%	2583	1127
2003	$226,565	-0.23%	1646	1869
2004	$228,661	0.93%	2753	4306
2005	$228,473	-0.08%	3632	4455
2006	$237,733	4.05%	4141	4321
2007	$240,343	1.10%	3188	4497
2008	$212,531	-11.57%	2563	1410

Source: (Haddow & Co.)

The Superstar City and the Superstar Condo

While irrational exuberance can explain the behaviors of buyers in Atlanta, what motivated lenders to approve these projects was a different story. While developers tend to naturally be optimistic, "swing for the fence" personality types, lenders themselves bear much more financial risk in funding a development deal, especially at the leverage rates common in the past few years. So what explains lenders' willingness to add to supply that even early in the decade appeared to be on the high side of the demand curve? I believe the Gyourko's theory of Superstar Cities was incorrectly applied to Atlanta by lenders funding projects. A MSA is categorized as a superstar if it exhibits high demand *and* it has a low elasticity of supply. Units in Superstar Cities trade at higher price to rent ratios, which expand even further as those cities "fill up" and supply becomes more constrained. Superstar MSA's experience disproportionate price growth when the number of high-income families increases nationwide. Recent movers into these cities are more likely to be rich and less likely to be poor than recent movers into other cities. (Gyourko, 2006) According to the Superstar City theory, certain MSA's should, in fact, be able to achieve outsize price gains in perpetuity because the composition of families living in those cities shifts to those who are willing to pay more as high income families become more numerous.

While Atlanta has positive population growth, especially among young, educated types, it also has almost unlimited capacity to expand real estate offerings to meet new demand. An opportunity to learn this lesson may have been missed due to the fact that lenders made it through the economic downturn of the early 2000's relatively unscathed, thus continuing the fiction that there was little risk of developers defaulting on debt service. Particularly vexing are the number of high-end luxury units that were approved, especially in non-core areas. While the average per square foot cost of condos in Atlanta is currently $199.01 per square foot, (Condo.com, 2009) many projects that are now distressed were initially offered at much higher multiples (see chart 3.2):

Chart 3.3

Project Name	Delivery Date	# of units	Avg. offer price	Units closed/ under contract
Downtown				
Renaisance Walk	2007-Dec	159	$305 PSF	20/20
Twelve Centennial Park	2007-Aug	517	$307 PSF	315/20
W Atlanta Residences	2009-Feb	74	$700 PSF *	0/10
The Atlantic	2009-Aug	410	$380 PSF	0/115
** Developer has since lowered price 30%*				
Proposed				
Aquarius Tower	N/A	120	$410 PSF	0/0
Midtown				
Luxe	2008-Aug	117	$387 PSF	5/30.
The Astoria	2008-Aug	70	$400 PSF	0/17
The Brookwood	2009-May	219	$450 PSF	0/0
Proposed				
Dewberry Ansley	N/A	58	$550 PSF	0/0
Trump Towers	N/A	363	$561 PSF	0/15
One Museum Place	N/A	96	$950 PSF	0/0

Source: Haddow &Co.

The dollar per square foot numbers on many of the proposed condominiums are staggering. Additionally, the number of contracts listed on several of these projects is misleading. As the W has lowered prices by 30%, it is almost unfathomable that early buyers will not either walk away from their deposits or sue the developer. The Atlantic is also widely believed to be in serious trouble, and the developer, Novare, is in intense negotiations to delay or reduce their debt maturities coming due this year. (Sams, 2009)

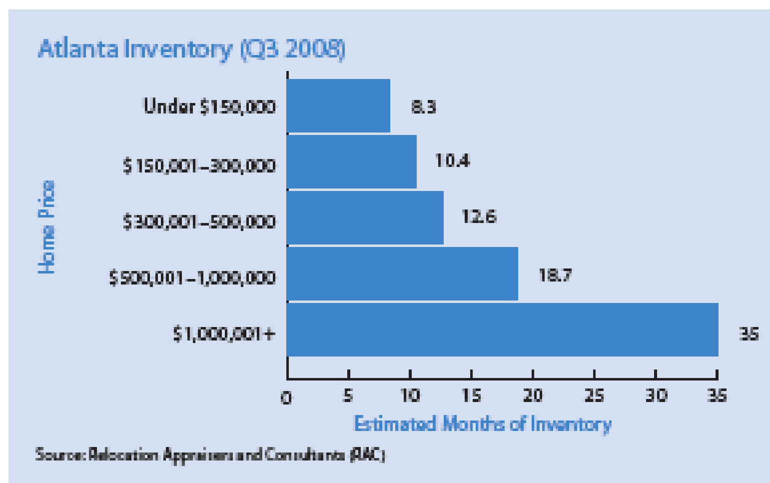
To some degree, much of the dispersion in asking prices across these projects was directly related to the confidence that investors and homebuyers had that they would live in what was effectively a Superstar condo

As an interview with Judd Bobilin, Novare chief development officer in 2007 indicated, Many factors can be attributed to Atlanta as a good location for condo development. Bobilin noted the city's expanding office market and positive job growth. In fact, he said Atlanta expects to add thousands of jobs over the next decade while also increasing incomes. "Atlanta's residents have embraced the urban living environment," Bobilin said. "Many of the new residents are coming

from urban environments like Chicago, New York and Los Angeles, looking to reinvent that same experience." (Gontar, 2007)

While buyers could be forgiven for believing that their units would continue to appreciate, especially given the pipeline of ever more expensive product, the condo boom in Atlanta was also a direct result of lenders' wishful thinking bias that their investments in the city and specific projects were somehow special. (Shiller, 2007) Thus, a herd mentality perpetuated development in intown as no one wanted to be left behind in what developers and lenders had convinced each other was a method of printing money. This was especially true in the super-luxury portion or the market, where there is now an acute hangover: (see Figure 3.1)

Figure 3.1



Source: Relocation Appraisers and Consultants

Units on the high side of the market represent a particular challenge for investors, as the monthly income from a rental conversion would likely not cover condo fees, maintenance and taxes. However, if bought at fire-sale prices, these units may yield exceptional returns when and if the sales market turns around.

Atlanta Overview

Atlanta is the 9th largest metro area in the country by population. The 20-county metropolitan Atlanta area (Atlanta-Sandy Springs-Marietta) rounds to 5.1 million people in 2008 comprised of

roughly 2 million households, growing 20 percent since 2000 (US Census). Of those residents, the highest density (4.1 million) reside in what is known as the “core 10” counties; Cherokee, Clayton, Cobb, DeKalb Douglas, Fayette, Fulton, Gwinnett, Henry, and Rockdale. The City of Atlanta itself occupies Fulton and Dekalb counties. Of particular import to this paper, practically all of the growth in multi-family units occurred in these "core" 10 counties (96.9%). (Atlanta Regional Housing, 2009) Atlanta has a younger population than the US average, at 33 vs. 36.4 nationwide, and has a much higher percentage of college educated adults, with 35.3% holding bachelor’s degrees or higher vs. 29% nationwide. Atlanta also has a high concentration of colleges and universities, ranking 7th in the nation both in higher education enrollment and in producing graduates with bachelor’s or advanced degrees. Atlanta also has a low cost of living compared to similar MSA’s with a housing price index less than half that of Washington DC and Los Angeles, and less than a quarter that of New York City (Atlanta Regional Growth, 2009)

Atlanta’s growth has been characterized by rapid population and job growth, particularly since the 1996 Olympics. While the city has a metrorail and bus system operated by the Metro Atlanta Rapid Transit Authority(MARTA), the city is notoriously pedestrian-unfriendly and historically has had few “walkable neighborhoods’ and vast suburban sprawl. The ‘intown’ area is bounded by the I-285 beltway and the I-75 and I-85 interstates pass directly through the city, providing easy access to South Carolina, Tennessee, Alabama, and Southern Georgia and Northern Florida. The Texas Transportation Institute showed the average Atlanta-area commuter wasting 57 hours a year going nowhere in traffic jams. Atlanta had the third-worst congestion in the nation, a better ranking than second-worst two years earlier when drivers wasted 60 hours a year idling. As a whole, the Atlanta area lost more time and money than ever to congestion: a total of 135,335,000 wasted hours in the year of the study, at a record productivity cost of $3 billion. (Shrank, 2009) Recently, development activity has begun to focus more on walkable communities and transit oriented development, including large high visibility mixed-use projects such as Atlantic Station, the proposed Atlanta Beltline, Ivan Allen Plaza, and the now-stalled Streets of Buckhead.

Chart 3.4

Table 1 – Cost of Living Index Average of 2007 (Q1) - 2008 (Q1)

US= 100	2007 Pop. (1=Largest)	Pop. Growth (1=Fastest since 2000)	Cost of Living Index Rank (1=Lowest)	Grocery Items 13% Weight	Housing 30% Weight	Utilities 10% Weight	Transportation 10% Weight	Health Care 4% Weight	Other 33% Weight
Atlanta	9	6	96.6 (5)	98.1	93.1	86.1	103.2	103.1	99.2
Austin		4	94.3 (4)	90.7	81.7	94.3	99.0	97.3	105.1
Boston	10		135.1 (12)	119.8	164.4	130.3	104.6	135.1	125.6
Charlotte		7	91.0 (2)	99.7	77.3	86.1	95.1	105.6	98.5
Chicago	3		111.3 (9)	108.5	126.3	110.6	111.9	103.6	99.7
Dallas	4	10	91.1 (3)	99.5	72.1	98.8	101.6	101.6	98.1
Houston	6	9	88.4 (1)	83.0	74.4	100.0	96.6	100.9	95.4
Las Vegas		1	110.8 (8)	99.4	135.8	103.2	103.8	105.7	97.7
Los Angeles	2		150.1 (14)	111.5	256.9	92.2	111.5	107.5	103.2
Miami	7		116.8 (10)	104.0	140.7	105.6	108.5	105.9	107.5
New York	1		218.2 (15)	153.4	401.4	152.2	121.1	127.2	139.7
Orlando		8	103.2 (7)	100.5	98.7	107.7	104.6	97.2	107.4
Philadelphia	5		123.7 (11)	125.1	144.5	116.4	105.2	110.1	114.4
Phoenix		3	101.2 (6)	101.2	101.9	94.4	99.9	100.1	103.0
Washington DC	8		138.8 (13)	106.8	214.2	109.9	107.5	109.1	105.1

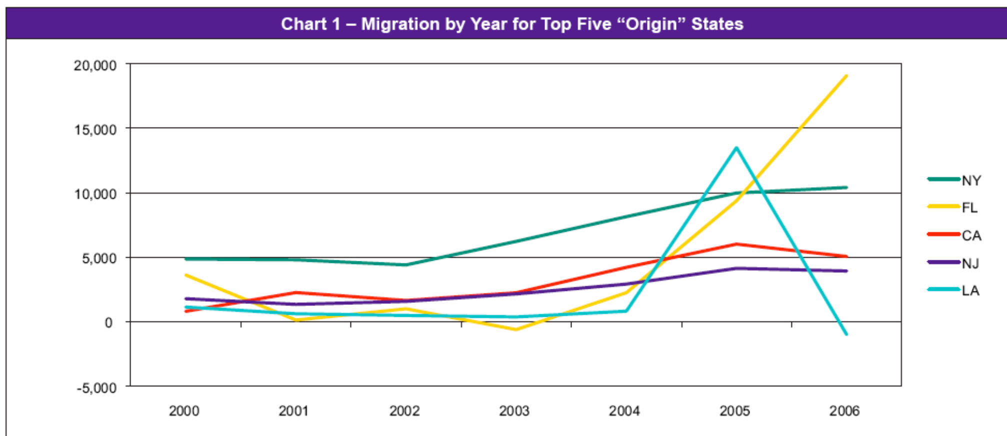
To learn more about the Cost of Living Index from C2ER, go to http://www.coli.org/surveyforms/colimanual.pdf

Source: (Atlantaregional.com)

In-Migration

Of particular note is the rate and pattern at which the region has been growing. When viewed from a population growth standpoint, it is easy to see why developers believed Atlanta was on its way to becoming a superstar city. The Atlanta region is a net importer of people, and this trend accelerated particularly strongly beginning in 2002. Net migration to the Atlanta MSA from 2000 to 2008 was 1,128,271. A 26% increase, making the region the second fastest MSA in the country. (Census, 2009) The top five feeder states for the region are New York, New Jersey, Louisiana, California, and Florida. Much of Louisiana's influx can be credited by what is known as the "Katrina Bump" of 2005, which added 14,000 people in 2005, but moved to a net outflow in 2007 (See Chart 3.4):

Chart 3.5



Source: Atlantaregional.com

As the chart shows, Net migration from Florida has surged recently, increasing dramatically beginning in 2004. This is a trend shared by all states analyzed in the chart, although it is more pronounced in Florida's case. Note that this data shows migration through 2006, a time when the housing prices were still appreciating at unprecedented rates. Thus it was still easy for those in Florida and other "hot" markets, like New York and California, to sell their homes for a profit and buy a comparable home in metro Atlanta for much less. As the housing market has crashed, so will these migration rates. (Atlanta Regional Growth, 2009). This presents a significant problem for the recovery of home values, and particularly to Atlanta condo values since the market for many of these units are the young single educated crowd that choose to live in urban areas. I believe that any investor who analyzes an investment in the Atlanta condo will have to pay special attention to their assumptions about these migration rates, and in particular, the nature of new migrants. As many existing homeowners now have either zero or negative equity to convert to a new home purchase, and first time homebuyers may have neither the cash or confidence to purchase, the positive population growth story my not translate into a similarly positive effect on condo sales prices or velocity.

While the city's fundamentals appear strong on paper, the unemployment rate as of May 2009 was 9.6%, the highest ever recorded, a staggering increase from 5.9% in May 2008.

Product Type

Depending upon the submarket, the product type developers offer usually falls into one of four categories:

- High Rise Apartment: Atlanta's fairly permissive zoning and readily available land allow for easy construction of impressive towers, many built on existing parking lots, or relatively underused plots. This archetype is particularly popular in Buckhead and Midtown, although several new projects have popped up in downtown, including Museum Tower, built in 2003, which was the first residential tower in Downtown since Peachtree Towers was built in the 1960's. The W Residences, and the Twelve Hotel and Residences are recent vintage examples of downtown residential towers. At the time of this writing, the W had only 9 units out of 74 under contract, and had reduced prices 30% on the remaining 65 units. Novare Group, the developer behind the Twelve, is in default on substantially all of its debt and is attempting workout talks with its lenders currently. Both of these projects are examples of the Condotel trend, which also includes the Twelve Atlantic Station and the Ritz-Carlton

Residences, both Novare developments. Condotels have been hit particularly hard by new Fannie Mae regulations governing financing of condos in mixed-use projects (See Chapter 5).

- Lofts: Lofts in Atlanta typically fall into the “true” or “hard” loft category, characterized by repurposing of industrial buildings, exposed brick, high ceilings, and large windows, and “soft” lofts, which were typically ground up developments whose only legitimate claim to “lofthood” is marketing and perhaps a wall or two of exposed brick. These types are particularly popular in fringe areas, and entire loft neighborhoods have sprouted in former industrial areas such as Peters Street in Southwest Atlanta. The Tribute Lofts, a “soft” loft project close to downtown completed a condo auction in June 2008, selling 26 units, but at the time of this writing, the building still had 12 units available.
- Garden Style apartments: These types are fairly prevalent in the Lenox road area of Buckhead, and are typically older developments. They typically consist of multiple buildings or wings of a single structure in a gated community. They typically include landscaped features, community amenities, and built-in roads. Because of their low rise nature and subsequent low density, they require more land, and have not been particularly popular with developers recently.
- Townhomes: These units are frequently found in suburbs fringe areas, and on Lenox road. Similar to Garden style apartments, they are both land and infrastructure-intensive and usually found where either developable plots are inexpensive or sales prices would justify the land use.

In terms of investment potential, there is no clear winner as far as product type. Multiple factors affect the marketability of various projects including build quality, neighborhood, uniqueness, and amenities. I make no recommendation as to what product type specifically in which to invest, but investors should conduct extensive due diligence, particularly in regard to maintenance and build quality. In Miami, many developers cut corners in both construction and maintenance as the building neared completion in order to conserve their cash. This may be a particular liability in larger projects where the common fees may not have been paid fully and maintenance was deferred.

Current state of the market

Atlanta's condo market is primarily divided between three main submarkets: Buckhead, Midtown, and Downtown. While there are other neighborhoods and locations which have experienced development activity, these three locations comprise the vast majority of available developed units. As of the end of Q4, 2008, there were 6,032 unsold actively marketed developer-sponsored condominium units in intown Atlanta, the area within the circular bounds of the 285 Perimeter freeway (see Chart 3.5). These units represent 46.3% of the total inventory of 130 projects. This does not include 742 units which were removed from the market due to conversion to rentals or construction halt.

Chart 3.6

Active Condominiums By Submarket

Submarket	No. of Projects	No. of Units	Units Closed	Units Under Contract	Unsold Units	Percent Sold
Downtown	13	1,568	809	107	652	58.4%
Midtown/Brookwood	22	3,340	1,193	252	1,895	43.3%
Buckhead	35	3,061	1,434	154	1,473	51.9%
Other Intown	60	3,268	1,180	76	2,012	38.4%
	130	11,237	4,616	589	6,032	46.3%

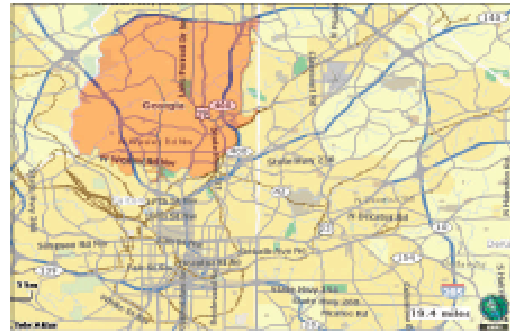
***Source: Haddow &Co.**

2008 was the wost year for condominium sales on record since The 1990's with only 645 units sold, and only 66 of those sold in the second half. Of the 130 active projects, ***60 did not sell a single unit in the second half of 2008.*** This is down from 1,704 units in 2007 and a peak of 4,747 units at the peak of the market in 2006. Of the 645 sold, 30 were the result of an auction at the Tribute Lofts in the Downtown submarket.

Buckhead Submarket

2009 Demographic Highlights[1]

- Total Population—84,690
- Median Household Income—$92,933
- Median Age—38.2



New Construction / Conversion	Absorption	Average Sales Price	Months Supply
1Q08	50	$515,838	—
change	-78%	+33.4%	—
1Q09*	11	$688,008	36.9

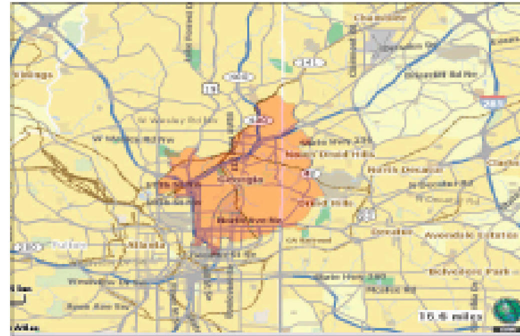
***Source: Prudential Realty NRT**

The increase in average sales price over 1Q08 is skewed by a $3.4M closing at Sovereign. Without this closing, the average sales price would have been approximately $409,000, resulting in a 21% decline in average sales price over the same period last year. (Prudential NRT, 2009) Buckhead is Atlanta's most affluent neighborhood , situated in the Noorthern end of the city northwest of Interstate 85 and northeast of Interstate 75. Buckhead is probably Atlanta's most well-known community, and has a high density of retail, office space, hotel, and high end residential rental apartments, houses, and condominium communities. Additionally, Buckhead contains the Phipps Plaza and Lenox Square malls, Atlanta's most upscale shopping destinations, with a Neiman Marcus, Saks Fifth Avenue, and other high-end shops. Peachtree and Piedmont Streets, Atlanta's most trafficked road streets, intersect in Buckhead. Buckhead has a higher supply of inventory than any other submarket, largely because the demand for the high-dollar condominiums developers have offered has dried up.

Midtown

2009 Demographic Highlights[1]

- Total Population—90,047
- Median Household Income—$70,424
- Median Age—34.4



New Construction / Conversion	Absorption	Average Sales Price	Months Supply
1Q08	51	$263,267	—
change	+45.1%	+5%	—
1Q09*	74	$276,467	48.8

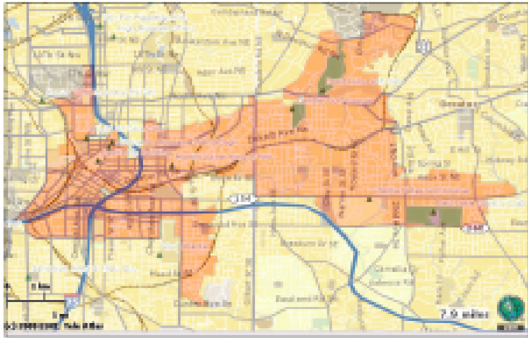
***Source: Prudential Realty NRT**

Midtown is the second largest financial district in the city of Atlanta, situated North of downtown on Peachtree Street. The I-75 and I-85 highways run through Midtown, joining to form what is known as the downtown connector. More gentrified than Downtown, Midtown has a heavy arts presence, including the Fox Theater, Woodruff Arts Center, and High Museum of art. The official boundaries of the district are the Beltline just east of Monroe Drive on the east, I-85 and I-75 to the north, Howell Mill Road on the west and Ralph McGill Boulevard on the south. Midtown also includes Atlantic Station, a large mixed use project containing office, hotel, retail, and residential space, and Atlanta's first Ikea. The area contains 22 million square feet of office, 3,300 Hotel rooms, and is home to roughly 30,000 residents. (Midtown Alliance, 2009) Georgia Tech and the Savannah College of art and Design are both located in Midtown. The Midtown Mile is a new redevelopment of the Peachtree Street corridor with plans to add three million Square Feet of office space, 2,000 additional hotel rooms and significant retail. Aspects of this project may be delayed due to the economic slowdown.

Downtown

2009 Demographic Highlights[1]

- Total Population—74,591
- Median Household Income—$41,482
- Median Age—31.8



New Construction / Conversion	Absorption	Average Sales Price	Months Supply
1Q08	68	$230,096	—
change	-79.4%	-5.0%	—
1Q09*	14	$218,693	4.5

***Source: Prudential Realty NRT**

Downtown Atlanta is the largest CBD location in Atlanta, and houses the city government offices, as well as a heavy concentration of Class A office space. There is some retail and housing, but downtown is generally regarded as a less prestigious and desirable neighborhood than either Midtown or Buckhead. Centennial Olympic Park is located in Downtown, and Phillips Arena, which hosts the Atlanta Hawks, the Atlanta Thrashers hockey team, and entertainment events is on Luckie Street. The Americasmart wholesale marketplace occupies seven million square feet of space. This area is bound by North Avenue to the north, Boulevard to the east, Interstate 20 to the south, and Northside Drive to the west. This definition of Downtown Atlanta includes central areas like Five Points, the Hotel District and Fairlie-Poplar and outlying inner-city neighborhoods such as SoNo, and Castleberry Hill. Downtown has a population of 27,000 residents, but is projected to grow to 39,000 by 2010. While the current household income is $44,000, the average income of new residents is $61,300, suggesting a strong gentrification pattern. (Downtown Alliance, 2008)

The substantial decline in absorption for both new and resale in the First Quarter 2009 over the same period last year can primarily be attributed to the current market conditions that are affecting the fringe neighborhoods, which are typically the first to decline and the last to recover. Downtown properties are losing market-share to other Intown neighborhoods, such as Midtown, which provide more lifestyle amenities, entertainment, and security. Downtown has also suffered

from a cascade effect as gentrifying development which promised neighborhood transformation slows.

From an investment perspective, Midtown and Buckhead should be viewed as core, mature markets. Downtown, while burgeoning is still considered a fringe market, and will likely demand lower rents and resale values for the considerable future. Many Atlanta residents fear crime in the neighborhood, and there is a higher proportion of vagrancy and homeless persons in downtown than either of the other two submarkets. Investors who are comfortable investing in non-core neighborhoods may see significant upside, however, as these assets will most likely trade at a significant discount to Midtown and Buckhead. The amount of overbuilding in terms of both office space and residential condos in Buckhead is particularly concerning. As many of these units require jumbo or non-comforming mortgages, the market has significantly thinned. That said, the neighborhood is still the most attractive in Atlanta. Midtown is an excellent neighborhood with growth prospects provided by the Midtown Mile initiative. As units in Midtown are usually much less expensive than in Buckhead, the ability to convert projects to rentals and then option them still exists.

From a citywide perspective, Atlanta's prospects are mixed. Georgia is in the midst of a severe recession relative to the country as a whole. Because of the high percentage of jobs in Atlanta related to construction and real estate. Atlanta's job losses are unlikely to reverse in 2010. Georgia's state GDP is expected to shrink 1.4% in 2009. Additionally, while economists expected unemployment to peak at 9% in 2010, Atlanta's unemployment rate has already breached 10%. Because of the banking crisis in Georgia, capital is extremely difficult to source, and CIT's restructuring may further cut into the debt availability for small businesses. However, prospects for growth post-recession are good as Atlanta's ranking as one of the lowest cost cities in which to live and do business is likely to attract more corporate operations. Because of the comparatively low cost of living and relatively inexpensive labor, Atlanta is also in a better position to add jobs than many cities once economic conditions improve. Atlanta's employment story is also not dependent on one industry. While finance and real estate are taking a beating, transportation has not been hit as hard. This degree of volatility supports my belief that Atlanta is an excellent location in which to mine the bottom and profit from an economic recovery.

Chapter 4: Market Participants

Who's Who and What's What

The sphere of real estate investing has always involved the participation of multiple parties. Distressed condo investing is no different, and in many cases, may require much more collusion, dealmaking, and negotiation amongst even more parties. This is particularly true of incomplete projects, in which A general contractor or construction manager may be also a part of the deal chain. I have omitted them from the following list because of their limited involvement in the financial aspect of distressed condo investing.

1. **The Developers.** Typically, in a distressed condo situation, the first loss is absorbed by the developer of the project, or their equity proxy. In the context of my research, it has been established that most developers of distressed projects began construction during the period between 2004 and 2007 with 15,818 units delivered into the Atlanta market over that period of time. The developer's motivation once the project becomes distressed is to minimize their loss of equity. To do this, they typically attempt to ensure that the bank recovers as much of the loan balance as possible to avoid recourse issues, to negotiate the debt down to manageable levels, or to extend the loan as long as possible to attempt to work out a situation in which their equity interests are protected. (Please see appendix for partial list of Atlanta-area developers)

2. **The Lenders.** Typically we refer to anyone who is currently holding paper backed by the project as a lender. While this may be a traditional bank holding a construction loan, this may also very well be a:

    - Commercial Mortgage Backed Securities fund.
    - Mezzanine debt.
    - Collateralized Debt Obligation issues. While not extremely common, during the past few years, investors in securities became more willing to take on paper backed high risk non cashflowing Construction and Development loans. These ware typically limited to Commercial Real Estate (CRE) CDO's(Lucas, 2007).

The lender's motivation is to recover as much of the loan balance as possible. This is typically achieved either by selling the note to a debt investor, extending the loan in the hope that the market will turn, renegotiating the loan terms with the developer, or foreclosing on the property and reselling the asset. As discussed earlier in this paper, Georgia is in the midst of a severe banking downturn due mostly to bad real-estate backed loans.

I believe this unique market attribute further supports my hypothesis of Atlanta as an attractive market for distressed asset investing because failed lenders will have no choice but to dispose of assets. Additionally, the market price of these assets can serve as valuable price discovery for both lenders and investors and may hasten the closing of the bid-ask spread.

3. **The Investor.** The investors can be stratified into two types: Sophisticated investors and unsophisticated investors.

    - **Sophisticated investors:** typically experienced professionals with access to capital and may include Private Equity firms, Opportunity and Vulture funds, and some High Net Worth Individuals. Among the Sophisticated Investors are groups with widely varying degrees of capitalization, risk tolerance, and real estate expertise. As such, the strategies and willingness to operate in this sphere may be radically different across firms which on the surface, appear to be very similar.

    - **Unsophisticated investors:** typically High Net Worth Individuals, or investors with access to some capital who have neither the experience or the bargaining power of sophisticated investors. Typically, these investors will do bulk deals in much smaller amounts (5-20 units) and at much less of an aggressive discount than a sophisticated investor could negotiate.

    - **Developers** themselves are also increasingly acting as investors using their balance sheet or access to capital to invest in either their own or others' distressed projects. Much of the impetus for that is a lack of other opportunities to deploy capital and

their realization that there is a dearth of skill to workout much of the operational issues associated with dealing with the asset.

The investors' primary motivation is to purchase the asset at a price and on terms that are most favorable to a profitable exit. The investor is the entity responsible for the most legwork in a deal as they not only have to meet internal investment hurdles, they must provide an attractive price to the lender, deal with the developer (assuming they've already been kicked out of the deal), placate or buy out existing unit owners or contract holders, and navigate the legal liability. I believe there will be opportunities for developers who are unhindered by distressed assets themselves to enter the space as advisers or co-investors with investment groups, particularly those that lack real estate focus and manpower. Developers may also find they can use their existing relationships with financial institutions to serve as the equity investor and gain elevated leverage arrangements through these partnerships.

4. **The Regulators.** While not a direct participant, the role of both the FDIC and the Treasury in the disposition of distressed assets cannot be overstated. While there is currently no "developer bailout", The Treasury has instituted the Legacy Securities Public Private Investment Partnership (PPIP) in March of 2009 for the direct purpose of assisting banks with disposing of toxic assets by providing incentives to investors to purchase these assets. These would come in the form of matching equity and FDIC financing to a multiple of six times the investor's equity. The program will use money from the Federal Reserve sponsored TALF and Treasury sponsored TARP funds authorized in the stimulus plan.

One of the problems banks faced in regard to toxic securities was that, since the market was so bad for them, the prices banks sometimes would settle for in order to get rid of them were fire-sale prices, i.e. very low prices agreed to because of desperation to get rid of the junk. Many holders of distressed paper argue that the hold-to-maturity values of many of these toxic assets are much greater than the values the securities had been sold for over the past year. That led banks to complain that they shouldn't be forced to value those securities at the market value. In other words, they should not be forced to mark-to-market, because those prices did not

accurately depict the securities' value because of a dysfunctional market caused by lack of liquidity.

Given ample evidence of investors on the sidelines with “dry powder,” it can also be reasonably argued that the supposed “lack of liquidity” was merely a ploy and that lenders were in fact, simply unwilling to sell assets at what the current market demanded. In response, a few months ago, shortly after the PPIP was announced, Financial Accounting Standards Board (FASB) -- the body that sets accounting rules/standards -- announced that they were changing mark-to-market requirements. FAS 157-e, as the accounting rule is called, allows banks to “mark to model,” valuing these assets at par or very close to it.

As a result of being able to hold distressed paper at non-distressed valuations on their balance sheets, lenders themselves had no incentive to clear assets at prices below what they were valuing the securities. The program effectively failed to gain any traction, and in early July, 2009, The Treasury announced Phase II of the program naming the several entities entities as participants in the Legacy Loan Securites Program, including Blackrock, Marathon Asset Management, and RLJ Western Asset Group. The Legacy Loan Program (separate from the Legacy Securities Program) is intended to boost private demand for distressed assets and facilitate market-priced sales of troubled assets. The FDIC would provide oversight for the formation, funding, and operation of a number of vehicles that will purchase these assets from banks or directly from the FDIC. Private investors would invest equity capital and the FDIC will provide a guarantee for debt financing issued by these vehicles to fund asset purchases. The FDIC’s guarantee would be collateralized by the purchased assets. The FDIC would receive a fee in return for its guarantee.

This funding mechanism draws upon concepts successfully employed by the Resolution Trust Corporation in the 1990s, which routinely assisted in the financing of asset sales through responsible use of leverage. At the time of this writing, no transactions have occurred through the program but the FDIC expects to solicit bids for this sale of receivership assets in July. In addition, the FDIC has stated that they will “continue to work on ways to increase the utilization of this program by open banks and investors.” (Treasury, 2009)

The effect on bank behavior due to these programs has been described by many of the investors I interviewed as a prime impediment to investment in distressed condo projects for two reasons. First, banks are extremely reticent to sell assets at prices investors would find attractive because doing so would trigger huge losses, which are not currently realized on their balance sheets due to the mark-to model rules. These losses would have the potential to render many banks insolvent under current reserve capital rules. Second, the implied promise from the treasury that the program may be modified or added to makes banks unlikely to foreclose on properties or sell loans unless absolutely necessary because of the potential for a higher government subsidized price in the future.

However, if successfully implemented, the PPIP will likely have one beneficial side effect to buyers of distressed condo assets: By disposing of securitized paper such as office towers and residential rentals at higher prices due to government risk subsidies, lenders will eventually be willing to take higher losses on paper related to unsecuritized condo project loans. Theoretically, the higher prices on securitized assets will cushion the blow from the lower prices lenders will eventually be forced to pay for whole loans. While the lender may be forced to recognize losses eventually, by playing the waiting game, they can avoid catastrophic losses. If lenders' capital reserves improve, their willingness to write down loans will cease to put their solvency in jeopardy.

Continued government intervention presents the greatest risk for an early entry into distressed condo investing. Without a clear understanding of what potential subsidies or changes the government will make, an investor risks leaving money on the table or assuming more risk than necessary. Alternately, a successful government program may actually boost distressed asset prices by building confidence in the market. It is impossible to forecast a probability of action outside of anecdotal evidence, but investors should be prepared for any eventuality and underwrite a number of scenarios.

5. **The Mortgage Lenders:** As a result of both the subprime meltdown and continued losses in the Alt-A and Prime sectors, as well as the effective death of the securitization market, mortgage banks have tightened lending standard significantly over the past year. Despite rates hovering at or around the 5% mark, otherwise qualified applicants who would have been approved for many different mortgage types are now finding it impossible to get a mortgage loan. Banks have increased down payment requirements as well as FICO cutoff scores.

"The credit pendulum is stuck at 'stupid,'" said Lou S. Barnes, an owner of Boulder West Financial Services, a Colorado mortgage bank. "I am turning down loans every day that my grandfather in his Ponca City, Okla., savings and loan in 1935 would have been happy to make. And he was tough." (Streitfield, 2009) The Mortgage Bankers Association of America (MBAA) had estimated that purchase mortgage originations in 2009 would be $821 billion but this forecast was lowered to $737 billion in June 2009, based on Q1 mortgage and sales volume. The availability of finance is particularly problematic in the condo sphere, and will play a huge role in the investors' exit strategy. One investor gave an anecdotal example of an investor who purchased a condo project at such a deep discount, he was able to write seller financed mortgages on the units to buyers and then resell those mortgages. However, this is a complex solution, rife with its own problems, and not appropriate for many investors, particularly those without a very strong balance sheet or buyer lined up for the mortgage paper.

If acquisition risk is centered around potential government action, divestment risk is most profoundly affected by this lack of available credit in the market. An investor who goes into a project without guarantees of unit financing risks having to carry the property for an uncertain and perhaps extended length of time. While an investor with a strong balance sheet may be able to offer seller financing, there is the additional problem of finding a buyer for those mortgages. If the risks involved make distressed condo investing attractive for small or entrepreneurial players, this lack of exit financing also makes it extremely challenging. This will be a particular problem for luxury and high end projects which cannot be converted into rentals.

Cousins, the developer sponsoring the Terminus condominium project in Buckhead released a self-financing scheme in March. Cousins is bypassing the financing issues, at least for three years, by offering up to 95 percent developer financing at a 4 percent. Unlike most developers Cousins is able to offer this very unique opportunity because it does not have a construction loan on the condo tower; the project's financing lies on the office towers.

There is also an incentive program for people who need to sell their house. Buyers who put 20 percent down can move in with no payments for a year. The 10 Terminus buying incentives began March 20 and is initially being offered on only 25 condos. How the market reacts to this strategy is yet to be seen, but this may be one of the few solutions for disposing of high-end residential, and projects that are not eligible for conforming loans. Because Cousins is particularly well-capitalized, they can afford to finance the purchases. The availability of capital to propose these terms at other projects, however, would be difficult at best in this environment. Terminus includes 137 units, of which 13 have been sold and an additional 17 were under contract at the time of this writing.

6. **Government Sponsored Entities.** A key player in the financing of condo purchases are the Federal National Mortgage Association (FNMA), better known as Fannie Mae, and the Federal Home Loan Mortgage Corporation (Freddie Mac). The two Government Sponsored Entities (GSE's) own or guarantee nearly half the entire market of U.S. home loans. The companies purchase mortgages from lenders, keep some for their own investment portfolio, and resell some to Wall Street investors as collateralized debt obligations or asset-/mortgage-backed securities.(wpcarey, 2009)

Under a plan announced September 7, 2008, the federal government, via the Federal Housing Finance Agency, placed the two firms into conservatorship, dismissed the firms' chief executive officers and boards of directors, and caused the issuance to the Treasury new senior preferred stock and common stock warrants amounting to 79.9% of each GSE. In March, Fannie Mae stopped guaranteeing mortgages in condo buildings where fewer than 70% of the units have been sold, up from 51%. A favorable change for condo sellers was that

units marketed for sale by foreclosing lenders as Real estate Owned (REO) now count as "owner occupied units." Thus, those units will not count against the 70% sold threshold. Developers can petition Fannie for an exemption from the 70% rule, and at the time of this writing, over 50 exceptions have been made, but they represent a small fraction of national projects.

While this modification received most of the public scrutiny, there are several other lesser studied but potentially equally disastrous clauses for developers and condo owners in the modification terms. Fannie Mae will not guarantee or repurchase loans for sales in buildings where 15% of current owners are delinquent on Homeowners Association (HOA) fees or where more than 10% of units are owned by a single entity. The calculation was also changed from being 15% of HOA fee payments to 15% of total *units* delinquent on HOA fees. This clause in and of itself makes the exit strategy for a bulk investor that much more difficult, as potential retail buyers will likely have difficulty financing a purchase from a bulk condo owner simply because the bulk condo owner may own too many units in the building.

No more than 20% of a Fannie guaranteed project can consist of non-residential space. This change has major implications for sellers of condotels (mixed use projects including condominium and hotel units, usually stacked vertically in a high-rise tower), of which there are several in the Atlanta market including the Barry Companies' W Residences, Novare's Twelve Atlantic Station and Twelve Centennial Plaza, the Ritz-Carlton Residences Atlanta, and the St. Regis Atlanta Hotel & Residences. Additionally, the Terminus project mentioned previously would be ineligible because of the office component of the building.

Several new changes were also added to ensure the stability of a project's Home Owners Association (HOA). The homeowners association must have at least 10% of its budgeted income designated for replacement reserves and adequate funds budgeted for the insurance deductible. Fidelity insurance, which protects organizations from loss of money, securities, or inventory resulting from crime, will also be required for condos with 20 or more units, ensuring that homeowner association funds are protected. This requirement originally applied to new projects but is now being retroactively extended to include established condos. Fannie

Mae and Freddie Mac both increased fees on condo buyers in April as well. Buyers without at least a 25% down payment now have to pay closing-cost fees equal to 0.75% of their loan, regardless of the borrower's credit score, increasing potential buyers' necessary cash to close.

An additional clause renders ineligible "new projects where the seller is offering sale/financing structures in excess of Fannie Mae's eligibility policies for individual mortgage loans. These excessive structures include, but shall not be limited to, builder/developer contributions, sales concessions, HOA or principal and interest payment abatements, and/or contributions not disclosed on the HUD-1 Settlement Statement." (Fannie Mae, 2008) This effectively destroys a developer's ability to contribute down payment or other cash to meet other Fannie guidelines as well as throws into question certain developer incentive practices. The general vagueness of the clause is also of concern. Without an effective secondary market in terms of either securitization or repurchase by one of the Government Sponsored Entities (Fannie Mae or Freddie Mac), lending standards are unlikely to loosen in the immediate short term.

Chapter 5: Challenges in bulk condo investment

In order to determine optimal strategy to invest in these distressed assets, I conducted research interviews with the following industry players: private equity investors, construction lenders, Atlanta real estate agents and data firms, and developers. I asked the investors a number of questions regarding their participation in the market and the diversity of their answers was fascinating.

The Opportunity. Put simply, all the investors interviewed had the same objectives: to create favorable returns by deploying capital into distressed assets via either purchasing debt or the physical asset itself and then profitably exiting the investment at a future period.

The Motivation. The motivation for investing in distressed condo assets for all investors is that the high levels of current distress provide arbitrage opportunities. Because of inefficiency of information and illiquidity in the market, investors believe they can invest in these assets at a lower basis than their true market value, and create greater spreads than with other investment opportunities.

The Challenges. The challenges to distressed condo investing are mind-boggling. The following paragraphs detail the most pressing concerns according to my interviews.

The Bid/Ask Spread. At the time of this writing, every investor I interviewed described the spread between what investors were willing to pay for assets and the prices at which banks were willing to sell these assets as the greatest single impediment to deals being closed. Most investors isolated three key factors in lenders' reticence to meet investors' offers for assets:

1.Lenders have no incentive to sell loans at current market prices. Because of the mark-to-model accounting rules described in Chapter 5, most lenders continue to carry construction loans on their balance sheets at par or close to par value. While estimates of the market value of these loans vary widely by individual project and by investors' unique underwriting criteria, it is safe to say that distressed asset investors universally value these loans and their collateral at significantly lower values than lenders. One of the primary drivers for the standoff is the risk of

bank failure if banks were to sell these loans at a discount. Because of capital ratio rules, the banks would be effectively insolvent, triggering an FDIC takeover.

A Vice President at a Real estate Private Equity Fund said "If the banks haven't taken writedowns, they're not going to part with their paper. At the prices my firm would be willing to offer, what we really think this deal is worth to give us, say, a 30% IRR, the bank would risk insolvency if they had enough of this kind of paper and they had to sell it all at these values." (Anonymous 1)

Despite how badly a project may be performing, banks are also doing everything in their power not to foreclose on distressed loans and take back properties. As long as a loan is performing and debt service is being made, banks will not enforce technical default rules and will work with borrowers to extend or modify the terms rather than take the property back. Lenders typically do not have the real estate operational expertise or the available manpower necessary to manage a performing property, much less one that has problems selling and may be incomplete.

A real estate private equity analyst sums up the banks' dilemma this way: "Let's say a developer is behind on his debt service. The project isn't pre-selling, you have people walking away from their contracts. Do you really think the bank is going to do a better job? They don't have the marketing team, the sales team, if there's punch list stuff, they don't have anybody to do that. So even if the developer royally screwed up, they're still really the best shot the bank has to not get killed on this thing. So yes, the bank will bend over backwards to keep the developer from just handing over the keys." (Anonymous)

In the Atlanta market, some of this reticence may be on its way out. As mentioned before, with the high rate of bank failures, there will almost certainly be assets that are forcibly disposed of, either by banks selling to raise much-needed cash, or by FDIC regulators. Additionally, Corus Bankshares is likely to be taken over by a private equity firm or the FDIC at some point. With some $533 million of debt backed by 11 condo projects, it is likely that whoever ends up with control of the bank will sell some or all of the loans.

2. Lenders don't yet know the true value of the loans or their assets. Due to the lack of transactions both in the debt markets and in the condo markets themselves, lenders have little reliable information with which to model the present value of the loans on their balance sheet.

"Given the scarcity of capital (in particular debt) in the market and the inability to forecast both economic and real estate recovery investors are having a difficult time understanding where current pricing is for most real estate asset types. Consequently they are seeking premium risk-adjusted returns. With the exception of owners that are in severe distress the current owners are making the decision to hold rather than sell at discounted prices. In the end, the owners of real estate are either "buyers" or "sellers" of their own real estate and make a determination on "holding or selling" based on current market clearing prices." (Anonymous)

In Atlanta's condo sphere specifically, the sheer dearth of arm's length open market transactions in the second half of 2008 illustrates a dysfunctional market. While no one disputes the market is overbuilt, few parties interviewed believe this level of distress is indicative of overall demand, or that it will continue ad infinitum, but lack of data points make realistic analysis extremely problematic. Multiple investors also blamed much of the current paralysis on the sometimes contradictory information being provided by the FDIC, the Treasury and the Federal Reserve concerning potential bailout programs. Many investors viewed lenders as waiting for a "white knight" in the form of additional government assistance in disposing of these toxic assets at higher prices. Most investors had at some point reviewed the PPIP program and agreed that the initial iteration failed because while investors would receive government subsidies, lenders were still not incentivised to dispose of the asset if it meant writing down a loan and been forced to increase capital reserves. While all investors agree that the plan failed to achieve its goal of clearing out distressed inventory, there was a plurality of attitudes regarding expectation of future government intervention. The most extreme of the negative expectations was "zero probability" due to "bailout fatigue" by taxpayers and political opposition. The other extreme attitude was a high likelihood caused by an expected continued weakness in the overall economy and home sales as, well as the fallout effects of employment losses in the construction and real estate industries, effectively forcing politicians' hand to offer a plan to stem losses or at the least, make them more palatable.

According to an Associate at a New York-based private equity firm, "Banks will wait out the cycle until they can get full value for the loans. The only people that are selling right now are banks that have had to foreclose and players exiting the space. Funds exiting Real Estate and people that have essentially either gone broke or had enough. Your core lenders, though, they're going to stick this thing through until either they're forced to sell or until they can get at least something approaching the whole value of the loan."

While there have not been enough transactions to date to perform adequate price discovery, most investors I talk to feel comfortable being able to underwrite an investment on a project to meet minimum IRR hurdles. The question for banks becomes whether or not they believe they are getting a fair price for their assets, and I believe this will come to light quickly as the FDIC begins auctioning off the assets of some of the Georgia banks. From that point, the ball will be in the lenders' court: If they feel market prices are sufficient to justify selling assets, a market will be created and these assets will begin trading.

3. Lenders are simply overwhelmed. Lenders are faced with something of a perfect storm of negative events. Many have had to cut staff due to previous losses, and are overburdened not only by dealing with bad loans, but with customers with performing loans seeking to renegotiate terms. As such, a foreclosure proceeding is usually the worst case scenario for the bank not only in terms of recognizing losses on the loan itself but from a human capital perspective as well.

4. Multiple parties involved Many developers used the easy credit of the mid 2000's to leverage their development projects to the hilt in order to gain maximum returns. While the construction lender may have the senior note, there may be multiple pieces of mezzanine debt in the capital stack with competing objectives.

These issues provide significant headwinds to investors looking to deploy capital into condo assets because of the risk associated with each level of complexity. In the case of projects which remain unfinished due to cash shortfalls, the number of participants may be even greater, as there is likely a construction firm or general contractor involved. In such a case, there may be litigation

occurring between the developer and the contractor for unpaid work, or the contractor itself may have financial distress which would prevent them from completing the project. Many investors mentioned that, for these reasons, in the hierarchy of attractive deals, bulk condo projects ranked near the bottom, especially considering the risk-averse nature of many funds and their institutional investors.

5. Lack of Debt Financing Available: Outside of apartment conversions, investors universally agreed that there is no debt in the market for distressed turnaround assets. Regardless of basis cost, investors found that even their traditional lending partners have no interest in financing speculative deals. Attractive financing for apartment financing itself was almost entirely dependent upon Fannie Mae or Freddie Mac secondary markets. While investors speculated that debt markets may come back at some point for properties with a longer hold period, leverage could not be underwritten, and if available would only serve as a boost to IRR's.

As one investor mentioned, "If it's a situation where we can meet our hurdle on a stabilized core office development, and we are finding those deals in the market, versus a busted condo deal where we have no idea what the market's going to do, it's not rocket science to figure out which one we're going to bid on. The potential upside really has to be huge for us to take on that level of risk."

This sentiment was not echoed by all participants in the interviews, however.
"There's debt out there. Not 2004, 2005 debt, but for a good project that can be scoped as apartment rentals, in real world terms….and by real world, I mean, probably falling rents for a period of time and a fairly conservative exit cap, there's certainly some leverage to be had, maybe 50-60%. As much as anyone tells you, they would do this just to turn around and flip units, the reality is that everyone's going to price these things as apartments because the mortgage market's so thin. So, yeah, if we see an attractive opportunity, we're comfortable we can get enough debt to get our returns in line with our investor criteria." (Anonymous, 2009)

Resale Market

Once distressed opportunities do become available, the primary question for the investor looking to flip the units is the potential resale price. For many high end projects, even at significantly discounted purchase pricing, rental income would not cover HOA fees and taxes, and resale at some point is the only viable play. Many investors do not feel that the current data sales points are adequate to forecast either demand or availability over the short term, particularly in light of changing economic data. While much was made of the appearance of "green shoots" in the macro economy in the first quarter, second quarter earnings and employment data suggested that the recovery is not yet on its way. Additionally, the effect of the changes to Fannie Mae's purchase and guarantee standards as discussed in the previous chapter will certainly make mortgage financing more difficult or condo buyers, but it is unclear how severe the effect will be because of the lack of transaction data.

One of the increasingly popular methods of condo sales in the Atlanta market has been condo auctions. While these transactions represent only a small sliver of the available for sale market, they represent additional data points for what the spot price of a condo is. As many of the condos in the Atlanta market are fairly undifferentiated, an investor can consider this data in estimating the current market. In the past year, auctions have helped move or close out inventory at the Tribute Lofts downtown, the Aqua in Midtown, the Duo, and the Cosmopolitan. One private equity associate warned however,

"If the auction doesn't liquidate the inventory, it's not really price discovery, is it? Don't get me wrong, you can get an insight into what some buyers are willing to pay, but you're not going to deploy significant capital into a project just because another building sold at whatever a square foot. Particularly if after the auction, there are still unsold units, because you haven't truly gotten to a market-clearing price."

A side benefit for investors, however, may be some level of price discovery for lenders holding assets. Another associate at a large firm expressed this sentiment:

"If you're a bank and you're holding this paper on a condo project, you're relying on the developer to sell the units at some number that allows him to satisfy the loan he took out. Now, if

he's trying to sell these things at $1,000 a foot and then the guy across the street puts up an auction and sells his units for $500 a square foot, and doesn't even sell all of them, maybe, well, you're going to sit down and have a pretty serious conversation with the developer. And that's where we see maybe banks realizing that the true market value of these things is what it is, not what they're marking it as. And that's when banks start thinking about taking back the keys and seeing if maybe someone else can get them a better result."

One particular auction, at the Aqua condos in Midtown, achieved what was thought to be a sellout at auction in May, but as of July 19, only 9 of the 20 condos sold had closed. (See figure 5.1) If in fact, the buyers are unable to close, an investor must assume that the actual market price at which a buyer will purchase and be able to close is in fact, even lower. Because of the lag in reporting time, this additional price discovery period may further extend the due diligence period.

Figure 5.1

Unit #	Unit Type	Bed/Bath	Approx. Sq. Ft.	Last Asking Price	Minimum Bid	Winning Bid	Price Per Square Foot	Closed Date	Sales Price	Auction Price Reduction
603	Cobalt	2 BR, 2 BA	2104	$736,900	$349,000	NA	Not Offered at Auction			
604	Turquoise	2 BR, 2 BA, Terrace	1723	$699,900	$319,000	NA	Not Offered at Auction			
702	Azure	1 BR, 1 BA	1060	$329,900	$179,000	NA	No Bids	6/15/2009	$173,500	52.59%
704	Sapphire	2 BR, 2 BA, Den	1820	$639,900	$299,000	$311,000	$171	Has Not Closed		
802	Azure	1 BR, 1 BA	1060	$339,900	$179,000	$182,000	$172	6/5/2009	$182,000	53.55%
904	Sapphire	2 BR, 2 BA, Den	1820	$659,900	$299,000	$317,000	$174	6/11/2009	$317,000	48.04%
1001	Emerald	2 BR, 2 BA	1478	$549,900	$249,000	NA	No Bids	Has Not Closed		
1101	Emerald	2 BR, 2 BA	1478	$559,900	$249,000	$251,000	$170	Has Not Closed		
1404	Sapphire	2 BR, 2 BA, Den	1820	$699,900	$299,000	$337,000	$185	6/19/2009	$337,000	48.15%
1502	Azure	1 BR, 1 BA	1060	$349,900	$179,000	$187,000	$176	Has Not Closed		
1602	Azure	1 BR, 1 BA	1060	$359,900	$179,000	$195,000	$184	Has Not Closed		
1605	Indigo	2 BR, 2 BA	1321	$474,900	$229,000	$262,000	$198	6/16/2009	$262,000	55.17%
1701	Emerald	2 BR, 2 BA	1478	$609,900	$249,000	$272,000	$184	Has Not Closed		
1705	Indigo	2 BR, 2 BA	1321	$489,900	$229,000	$273,000	$207	5/21/2009	$272,000	55.52%
1805	Indigo	2 BR, 2 BA	1321	$494,900	$229,000	$285,000	$216	Has Not Closed		
1902	Azure	1 BR, 1 BA	1060	$379,900	$179,000	$211,000	$199	Back on Market		
2002	Azure	1 BR, 1 BA	1060	$389,900	$179,000	$211,000	$199	6/29/2009	$211,000	54.12%
2004	Sapphire	2 BR, 2 BA, Den	1820	$749,900	$299,000	$369,000	$203	6/12/2009	$396,000	52.81%
2104	Sapphire	2 BR, 2 BA, Den	1820	$759,900	$299,000	$402,000	$221	Has Not Closed		
2204	Sapphire	2 BR, 2 BA, Den	1820	$769,900	$299,000	$407,000	$224	6/29/2009	$407,000	52.86%
		AVERAGES	1475	$552,250	$248,500	$279,500	$193		$284,167	52.53%

atlantaskyrise.com

(Atlantaskyriseblog, 2009)

Chapter 6: Strategies

This paper has characterized the market forces, environment, and challenges involved with distressed condo investing. This paper focuses on mainstream strategies which can be executed by investors and which my interviews have confirmed are feasible. These strategies are ranked from least risky to most risky. I have omitted strategies such as buying and warehousing development projects because it is out of the scope of this paper. I also have omitted radical repurposing such as conversions to dorms ort hotel. While these may be effective plays in rare circumstances, that is a niche specialization business which is also outside the scope of this paper. Based on this evidence, the following represent recommended strategies for investors considering these assets:

1. Purchasing Debt to Maturity: This is a relatively simple strategy in which an investor purchases a slice of the capital stack on a project which may be experiencing some distress but is expected to perform. In effect, the investor is conducting a workout but as opposed to performing the service for the bank, the investor is purchasing the loan and reworking the terms so that the developer can meet their debt service. This can provide a valuable service to the lender as it can provide them liquidity and remove risky assets from their balance sheet while the investor will be able to make a fair return by purchasing the paper at a discount to par value. This strategy can be used to particular effect in projects that are nearly sold out or where the lender is under stress and there is an arbitrage opportunity.

Advantages: Exposure is to the debt, not asset itself, developer who knows and can manage the project stays in the deal, typically short time horizon

Disadvantages: Expect heavy competition from opportunistic capital sources for prime assets, potential exit risks if developer cannot complete sales strategy, if forced to foreclose, investor must have a backup plan to manage the property and complete sales process

2. Apartment Conversions of Completed Projects: This strategy is something of a best of both worlds play in that it allows for a less risky apartment play with possible leverage and the option of converting to high-yielding condos in the future as markets allow. There is a precedent for doing this, as many developers themselves have converted condo projects to rentals before distress levels reached crisis levels. Additionally, this is the only method for which reasonable

debt financing exists. Any entry mechanism can be used, from purchasing bank-owned assets to buying debt and either foreclosing on the property or completing a workout deal with the existing developer. This method also requires the least real estate expertise from investors as management duties can be outsourced to any number of local and national firms that specialize in such work. This strategy must be targeted to appropriate targets, however. Units built at the extreme luxury end of the market will not be suitable for this type of investing as rental revenues will likely not cover common fees and taxes unless the basis is extremely low, at which point a conversion investor is likely to be outbid for the asset by a "flip" advisor. This strategy is also contingent on a hurdle rate of units being sold. Most investors interviewed agreed that above 10% occupancy, this strategy becomes prohibitive because of either buyout costs for individual unit owners or litigation costs. This strategy also is likely incompatible with condotels as the potential revenue loss from a high end hotel would drag down performance of the building as a whole. The option to convert the units back to for-sale units is also extremely attractive, as the exit prices for these strategy may be above the exit price for the project as an apartment building during the next positive real estate cycle.
Advantages: Multiple entry strategies, debt financing available, ease of execution, simple operating structure, option to reconvert to for-sale units when market adjusts.
Disadvantages: Only works on low to medium end of the market, requires substantially vacant project, effect of flood of rental units likely to further depress market, long exit timeframe.

3.**Reselling Units in a Complete Project**: This is a riskier strategy than the apartment model, but may offer significantly higher returns and a shorter investment horizon as well. This strategy is very much contingent on buying at a low enough basis to profitably exit at a discount to what the prevailing market price is, especially if the investor requires a short time horizon. As a strategy, this is being played out in San Diego, by an Atlanta based developer, the RADCO Cos., who bought out the equity interest in The Mark, a downtown luxury condo building and has succeeded in selling roughly two dozen units of the 244 unit building, by lowering prices, and increasing marketing. RADCO was able to source the opportunity partially because the original developer's financing partner, Lehman Brothers, went bankrupt. I believe this is an excellent strategy for developers with available capital who are familiar with the market and may have some brand equity and intellectual and operation capital to offer. As opposed to fully funding a

deal, there are numerous entries an investor can make into a similar project including recapitalizing the developer directly, buying mezzanine debt, or buying the senior note. In a case in which a lender has taken back the property, it may also be possible to purchase the title to the property itself.

Advantages: Possible large discount to asset value acquisition, ability to leverage intellectual capital and experience, possible fee-based or sweat equity entry point, short investment horizon.

Disadvantages: Lack of readily available mortgage financing makes exit strategy risky, potentially expensive holding costs, particularly for high end product, may require real estate expertise.

4. Competing Incomplete project for rental or resale: Perhaps the most risky of the available strategies, investors may choose to purchase debt or equity positions in condo projects which for whatever reason are not finished. This is such a risky strategy because in addition to purchasing the asset itself, the investor will almost certainly have to commit additional equity to complete the project. This also requires significant management and operations oversight as a general contractor or construction manager will need to be involved to physically complete the project. Following that, a sales, marketing, management, and operations staff will have to be assembled to sell or lease the property. This type of investing should be the exclusive province of developers or those investors who have a partnership with a strong developer. Investors who partner with developers o deals like these should ensure the developer has an equity stake in the project so they have "skin in the game" and structure the returns so the developer is ensured of staying in the deal even if the unexpected should occur. This will protect the investor form a "walk-away" by the developer. For a non real-estate focused entity, a more likely entry point would be to recapitalize a developer who is already in the project. This would ensure an experienced entity was available to handle the operation side of the project, and by providing a "hope certificate" (share of return if specific hurdles are met), the developer will have incentives to complete a successful project. The most obvious downside is that if the project was ill-conceived in the first case, this may be an opportunity to throw good money after bad.

Advantages: Potential to acquire assets at true fire-sale price, more profit potential in the deal, likely fewer bidders

Disadvantages: Investor is taking on the risk characteristics of a development deal, potential additional risk from litigation and/or issues with contractor or other partners, complexity, real estate knowledge required, extensive due diligence and research necessary, asset holder not likely to be forthcoming about problems with the project

Chapter 7: Conclusion

The mission of this thesis was to characterize the environment, opportunities, and challenges of investing in distressed condo assets in Atlanta. I have provided a brief snapshot of the macro economic environment, the local real estate environment, and the historic precedent for distressed condo investing. I have established the psychological and economic factors that led to overbuilding and I have provided additional texture in the form of interviews with industry professionals. Finally, I have made specific recommendations for investors as to what type of investments are available, and their unique advantages and disadvantages. By examining these factors, a potential investor will be able to use this paper to determine whether to invest in distressed condo projects in Atlanta, and if so, what strategies and opportunities are available to investors of their specific expertise, capital, and risk level. As expected, distressed condo investing is an extremely complicated investment strategy, even in the context of distressed asset investing in general. While many professional investors shared similar views of the market, each brought a unique slant to their preferred type of investing, risk tolerance, and expertise level.

I believe government initiatives are critical to helping get the asset trading market back on track, and politicians are already in a hole with investors because of the perceived risk of government intervention in a firm's business if it chooses to partner with the FDIC or Treasury. Additionally, investors realize that if they make 25-30% returns on these investments that are backed by government guarantees there is a possibility that they will be asked to return profits or be thrown in front of Congress and berated. Regulators must ensure investor confidence that the rules of the game are set, and that investors will not be penalized for making shrewd investments.

In my opinion, the best opportunities are available to those investors who are able to convert projects to apartment rentals in the short term and reconvert them to condos when the market comes back. With the lack of financing for condo mortgages and the dramatic uncertainty about the economy, many buyers are simply out of the market right now. Investors who bought units to hold for a few months and resell at a profit have fled the market, and are unlikely to come back, and first time homebuyers who were formerly chomping at the bit to buy lest they get priced out of the market have realized there's no rush. Additionally, as many potential migrants' home equity has vanished, they will either stay put, or if they do move, likely rent. Many of the condos

available in Atlanta are Class A buildings with upgraded finishes that will likely be able to be purchased at a significant discount to construction cost. These units will compete very well with purpose built apartments with fewer amenities and inferior quality finishes. I believe the most dangerous deals are the high end condo units in Buckhead. While there is significant distress in this market, I believe it will be very difficult for an investor to resell these units at anywhere near the prices at which they are currently being offered.

I believe it is incumbent for investors who want to take part in these deals to begin raising capital and putting together teams of human capital to execute deals immediately. Investors should be ready to take advantage of opportunities that will surface in the next six months as more bnaks fail and the government feels more pressure to be proactive in turning around the economy.

Because of the lack of firm data points and completed transactions to this point, this thesis was intended to provide a fleshing out of the Atlanta market as well as provide a road map for prospective investors to formulate strategy and approach the investment. I conclude that Atlanta will most likely have excellent prospects for acquisition of quality assets at discounted pricing. My research has also suggested that there will be a limited number of players in the space, and those that do invest there should be able to achieve significant returns with a well thought out and executed strategy. The nature of real estate investing revolves around the management of risk, and my research has shown that bulk condominium deals are particularly risky. I have identified political risk as one of the largest risks. Uncertainty about further government action related to lending institutions and toxic assets is a challenge for both those who currently own these assets and those who seek to invest in them. I have also established that economic conditions will be a continuing force of uncertainty. As Atlanta's economy has been battered with job losses and a potential flattening of in-migration, investors will need to keep a watchful eye on employment, business, and development. Given the fluctuating nature of the economy and the intense political involvement in the world of finance, it is difficult to ascertain the optimal timing of investments. What investors should take away from these characteristics is that they must be compensated for assuming these risks. It is my belief that an investor who carries forth the recommendations in this paper will do exactly that.

Works Cited

Atlanta Downtown. Atlanta Downtown Counts 12 July. 2009
http://www.atlantadowntown.com/business/statistics/downtown-counts

Atlanta Regional Comission Population Data. Atlanta Regional Comission 3 July 2009.
http://www.atlantaregional.com/html/3938.aspx

Atlanta Regional Comission Regional Snapshot. Atlanta Regional Comission 7 July 2009.
http://www.atlantaregional.com/arc/documents/pah2007.pdf

Baker, Dean. "The Run-up in Home Prices: Is It Real or Is It Another Bubble," Center for Economic Policy Research Briefing Paper, 2002

Beleaguered Fannie Mae and Freddie Mac: Beacons of Stability WP Carey 24 June. 2009
http://knowledge.wpcarey.asu.edu/article.cfm?articleid=1644

Belke, Angsar and Wiedmann, Marcel. Boom or Bubble in the US Real Estate Markets. *Intereconomics* (September 2005): 5-6

Bergsman, Steve. After the Fall. New York, John Wiley and Sons, 2009

Bert Ely. "Savings and Loan Crisis." The Concise Encyclopedia of Economics. 2008. Library of Economics and Liberty. 21 July 2009.
http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html

Cassell, Mark K. How Governments Privatize: The Politics of Divestment in the United States and Germany. Washington: Georgetown University Press. 2003.

Entrepreneur Investors seek profit from RTC bad-loan auction. June 11. 2009.
http://www.entrepreneur.com/tradejournals/article/15443117.html

Fannie Mae Announcement 08-34, December, 2008

Fefer, Mark. RTC DEALS: ARE ANY GOOD FOR YOU? Money Magazine June 4. 2009
http://money.cnn.com/magazines/fortune/fortune_archive/1992/11/16/77129/index.htm

Gontar, Elena. Atlanta Developers Postone Construction Deals. Commercial Property News. 9 July, 2009
http://www.commercialpropertynews.com/cpn/content_display/regions/southeast/e3i30b29365238b365292126d92a5ffe48c

Gyourko, Joseph & Mayer, Christopher & Sinai, Todd. Superstar Cities. 12 July, 2009
http://www.nber.org/papers/w12355.pdf?new_window=1

Haddow & Co. Condominium Market Review, Intown Atlanta, 2008 Haddow And Company. Atlanta, GA. 2009

Henson, Dale, Interview with Solid Source Property Management. 9 June, 2009 http://sspmblog.solidsourcepm.com/2009/06/atlanta-rental-market-update/.

Herszenhorn, David. Congress Sends Housing Relief Bill to President. New York Times. 27 July, 2008

Lucas, Douglas, Goodman, Laurie, Manning, Rebecca,& Fabozzi, Frank. Developments in Collateralized Debt Obligations: New Products and Insights New York. John Wiley and sons, 2007

Midtown Alliance. Midtown Market Report 2007 7 July. 2009. http://www.midtownalliance.org/Documents/midtown_community.pdf

Nanda, Sudir, Owens, James, Rogers, Ronald. An Analysis of Resolution Trust Corporation Transactions. Real Estate Economics, Summer 1997

Paletta, Damian & Fitzpatrick, Dan. Failed Banks Dot Georgia's Vista. Wall Street Journal http://online.wsj.com/article/SB124458498208199637.html

Prudentail Realty NRT The Development Advisor First Quarter 2009 Prudential Realty. Atlanta, GA. 2009

Population Estimates. US Census Bureau. 15 July 2009 http://www.census.gov/popest/metro/tables/2008/CBSA-EST2008-05.xls

Press Release, Treasury Public Affairs, July 2009

Rauch, Joe. Bank to auction $100 million in troubled assets. Atlanta Business Journal. 19 June, 2009

Sams, Douglas and Hutchens,Turner. Condo Developer Facing Mountains of Debt Atlanta Business Chronicle. 27 May. 2009 http://atlanta.bizjournals.com/atlanta/stories/2009/07/13/story1.html

Shrank, David & Lomax, Tim. 2009 URBAN MOBILITY REPORT. Texas Transportation Institute, The Texas A&M University System. 2009

Streitfield, David. Tight Mortgage Rules Exclude Even Good Risks. *New York Times.* July 10, 2009

Thompson, Laura K. Picking up the Pieces American Banker; 28 June 2001,
Webb, Bailey. Atlanta's Condo Market Teetering. National Real Estate Investor Online 14 June 2007

http://nreionline.com/property/multifamily/real_estate_atlantas_condo_market/

Wei, Lingling & Timiraos, Nick. Starwood in Bidding for Corus. Wall Street Journal. 14 July. 2009

Weiss, Lois. Bulk Condo Sales Heating Up Real Estate Weekly 27 July. 1994 http://findarticles.com/p/articles/mi_m3601/is_n51_v40/ai_15812398/pg_2/?tag=content;col1 7 June. 2009

Wilber, Tony. Be Prepared For the Second Coming of the RTC 21 May. 2009. http://skylineviews.typepad.com/skyline_views/2009/05/be-prepared-for-second-coming-of-the-rtc.html 18 July. 2009