Analyzing and Appraising Condominium Projects

by Percy E. Wagner, M.A.I.

PROPERTY RIGHTS IN LAND historically have been interpreted as rights *on* the surface of the land or *in* the ground, with little attention to property rights existing *above* the surface. The enactment of condominium laws in many states has helped to change this concept of property rights, and living in and holding title to "a part of the sky" has become a popular form of ownership.

A SUCCESSFUL PROJECT

The success of a condominium project depends upon several factors. First, it is necessary that condominium units offer *greater advantages* than apartment units, and do so at the same or less occupancy cost. Otherwise the units will be at a competitive disadvantage to apartments because condominiums require a commitment and an investment in permanent ownership.

The condominium should also offer amenities that are equal or superior to the amenities of single family homes. Some of the more attractive amenities that a condominium can offer are location, view, large room size, convenience of transportation, and freedom from maintenance and other chores of home ownership.

The advantages of tax deductions for interest and property taxes and the accrual of equity through mortgage reduction provide the condominium owner 25% to 35% less cost of occupancy over renting. However, the purchaser will carefully weigh the cost of the equity down payment on a condominium against the advantages of a non-permanent lease.

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APPRAISAL—UNKNOWN FACTORS

An apartment building can be appraised by conventional appraisal methods, but the appraisal of condominium projects presents several unconventional problems. For example, the capitalization method may be based on a comparison of condominium units with rental units which may or may not be condominium owned. The market approach may be difficult to use because insufficient comparable properties have been sold (and re-sold) to establish a market. View, height, location in relation to stairways, elevators and recreational facilities, and other factors affect the desirability of a unit to potential purchasers. Only the sale and resale of units will establish the premium the market puts on these factors.

The appraisal of a low-rise or garden-type condominium[1] project is not as difficult as the high-rise. Because each unit is attached to the ground the problem of valuing air rights is not present. Each unit has a space on the ground and the common areas include ground areas, such as walks, gardens, pool and access streets or parking areas.

Space for parking presents no problem and is often a part of the access area to the unit. The garden-type condominium projects will probably prove attractive to those seeking a country environment whereas condominiums in close-in urban areas will have desirable cultural, educational and employment advantages for city dwellers.

THE CREATION OF A CONDOMINIUM

In the analysis of a condominium proposal the significant ingredients according to importance are:

LOCATION

a. Size of the ground and provision for light, air and attractive views.
b. Access to public transportation or highways, expressways or boulevards which make traveling to work, shopping or recreation convenient.
c. New or older neighborhoods which have status appeal.
d. Convenience of schools, churches and other cultural activities which have appeal to the home owner.

ARCHITECTURE AND LIVABILITY

a. Attractive exterior appearance and lobby decor.
b. Large and livable rooms with at least 15% more square feet per room than commensurate apartment rooms.
c. Large closets with at least one walk-in closet and one storage closet within the apartment area. Laundry facilities either within the apartment or on the floor.
d. Apartment foyer.
e. If high-rise luxury building, a swimming pool or a recreation room suitable for either individual parties or community gatherings by owners within the building.

1. See illustrations of low rise & garden-type projects, *The Appraisal Journal*, Jan. 1970, p. 75.

ENGINEERING AND CONSTRUCTION

a. Fireproof and noise-resistant walls between apartments.
b. Individual heating and air-conditioning within the apartments.
c. No more than four apartments to a floor per elevator.
d. Sound-proof elevator operation.
e. Refuse depository from each apartment or floor to basement.
f. Open or enclosed porches depending on location and climate.
g. One bathroom for each bedroom plus one powder room for each apartment.
h. Wind- and sun-resistant windows and frames.
i. Garage facilities of one or one and one-half spaces per unit depending on location.
j. Provision for both passenger and service elevators in high-rise buildings.

It should be noted that consideration must be given to the *status appeal* of the building so that regardless of the number of rooms per unit or the variance in unit prices, the same feeling of economic importance is conveyed.

SPONSORSHIP—MAJOR CONSIDERATIONS

The sponsor of a condominium project must comprehend the difference between promoting a building in a *rental* market and in a *sales* market. To most people who *rent,* moving is a way of life, and they do not seek the permanence or stability in living quarters that the home owner—or the condominium owner—demands.

Regarding *financing,* the sponsor must recognize that he has a horizontal subdivision and that sales may occur *inversely* to his construction progress. Financing must be different than that of the land subdividor who releases his land or his units from a blanket encumbrance as sales are made. The method of physical construction requires an analysis of the sponsor's ability to provide more equity funds for construction purposes and imposes different mortgage payout and release procedures.

CONSTRUCTION MORTGAGE

The application for a condominium construction mortgage need not vary from the application for an apartment building mortgage. The appraisal process may differ, in that the project may be appraised *either* as an apartment building or as a condominium project. The method of payout will follow the requirement that equity funds be disbursed before opening the mortgage and that mortgage funds will complete the building. This problem may present greater risk in the case of the condominium construction mortgage than with the apartment building mortgage. The condominium project may have from two to 200 owners who desire changes in specifications on their individual units. These changes are agreed to between sponsor and purchaser but may or may not be paid for at the time of approval. The mortgagee may not be aware of changes and additional costs may not be covered in the mortgage proceeds. Inspections therefore must be more frequent and affidavits should be obtained from the sponsor, architect and unit owners at each payout to avoid controversy at a later date. A deposit for extras must be made to the mortgagee by the owner or the sponsor.

At the opening of the loan, it is crucial for the mortgagee to ascertain that all contracts are firm, that no hidden financial arrangements exist between the sponsor, purchasers and contractors for an equity interest or some secondary security for payment of his contract. When controversies arise, unknown subterfuges are revealed and the persons involved create further complications.

PAYOUTS

Whereas the apartment project has *one* owner, an individual, a corporation, partnership or any other form of legal entity who also serves as the sponsor, the condominium project has one sponsor-builder and individuals who are vitally interested in their particular unit in terms of individual home ownership. All condominium purchasers do not make changes but the possibility of requested changes is present. Structural changes for example will affect the timetable of construction, requiring additional deposits for interest, insurance and taxes during construction. In large projects this can be very costly, necessitating changes of estimates in the application and statements prepared prior to opening the mortgage.

Protection from possible liens may be overcome by completion bonds binding on the subcontractor as well as the general contractors. Payouts may be made through a title company which examines individual contracts at each payout and guarantees against liens up to the time of payout. This procedure may or may not constitute full protection because extras are not always included and may not be taken into account by the title insuring company. Affidavits are sound legal documents but do not protect against law suits or construction stoppage by a contractor or subcontractor who is not being paid nor does the initial contract provide assurance of the cost to complete. Rising labor and material costs are difficult to anticipate in times of rising costs, and contractors will not accept a contract which cannot be fulfilled because of conditions beyond his control.

MORTGAGE PARTICIPATION

When two or more mortgagees join in a construction loan, the procedure for making payouts must be varied. One of the associations may act as the payout agent for the project and the participating mortgagees reimburse the paying agent after each partial payment or at the completion of the project. If one mortgagee does not assume the role of principal or the loan exceeds the legal limit of one lender, the participating mortgagees may join in an escrow agreement with a title company, which becomes the payout agent. The title company, when asked by the mortgagor for a partial payment, orders an inspection and obtains the necessary orders, waivers and inspection reports on construction progress from the architect, sponsor and general contractor. Upon approval of the necessary documents, the title company asks the participating mortgagees for their share of the payment and disbursement is made.

Mortgage participating by a number of mortgage lenders has many advantages. The risk of high concentration of funds is limited; the problems of inspection, approval and liens are reduced and mortgagees are assembled with more uniform processing and analysis of risk. If an examiner finds one participant's documents in good order, an examination could be waived by other participants.

During the period of payouts, many mortgagees require a *later* title date as a check on encumbrances which may have been recorded between payouts. When a title or escrow company makes disbursements, this procedure may not be necessary. Before final disbursement, it is advisable to escrow the final disbursement and order a later date but if disputes arise over payment, changes or extras, this procedure will not protect against possible liens.

When individual mortgages are placed on the units, the procedure for payout is modified. Before making a first payout on an individual unit, the disbursing agent must ascertain the cost to complete the unit and the common areas and as work progresses partial payments are made. This procedure allows larger payments from individual mortgages on work completed and does not require the holdback of the total common area cost. Supervision must be more intensive and the allocation of funds estimated more accurately with greater knowledge of construction costs. The sponsor can utilize unit mortgage funds and in some instances, funds deposited by the purchaser if *authorization* is obtained from unit owners to use these funds. The unit owner, by permitting the use of his mortgage funds, assumes risk of completion and must rely to a greater degree on the sponsors' responsibility.

DECLARATION

The condominium *declaration* created before first sales, should provide for condominium ownership to be effective when 51% or more of the units are sold. The possibility of a project becoming a rental project is always present. Sponsorship responsibility, sales ability, appeal of the project and many unknown factors determine a proposed project's success.

The advantages of condominium ownership such as reduced personal care, expense of maintenance, lower taxes and the home amenities in apartment living are becoming continually more attractive to present and prospective home owners. The market is improving and numerous resales are being made.[2]

2. A recent survey reveals that condominiums are showing increasing strength in the local markets and are attracting interest in at least one new market, Dallas. In Chicago, condominium sales are gaining and many new rental units which overran their cost projections are being converted to condominiums. In Detroit, both new and converted condominiums are increasing and in Los Angeles, condominiums once concentrated in the higher-bracket Westwood and Marina del Rey areas, are spreading to all sections of the city. (Shiefman, Werba, & Associates)

The greatest potential for condominiums exists in suburban areas where a country atmosphere combines with carefree suburban living. The planned city of the near future (now on the drawing boards) will provide country living to families which heretofore have been restricted to expensive homes or crowded city apartment living.

AVOIDING PITFALLS

Location and *sponsorship* are crucial to the success or failure of a condominium development. However, location is slightly more important because a good location and a relatively well designed building will pull inept sponsorship out of an otherwise bad situation.

LOCATION

The project's location must have established prestige if the project is not large enough to create its own environment and average apartment locations should be avoided. The most successful condominiums in Chicago have been along the lake shore, appealing to *upper* income classes, wherein the location played the crucial role. In the *suburban* areas many medium-priced condominiums have been successful because of their appeal to a *middle* income group who prefer owning over renting. In these cases, price was the principal influence. High rents in rental property could not compete with condominium carrying charges.

FINANCING

Sponsorship entails analysis of know-how and financial responsibility and sponsors must have development experience. Condominium development requires analysis of markets, neighborhood appeal, economic and social status, architectural vision and use of new products. The apartment building concept is not acceptable to the condominium buyer who expects new design, the feeling of possession, greater livability through better use of space and more attractive views and vistas created through height or landscaping. The attractiveness of a condominium lies in its superior architectural appeal, the size and equipment of the units and location. Financial advantages alone are not sufficient to attract buyer interest to "just another apartment."

Greater financial responsibility by the sponsor is necessary for two principal reasons: The mortgage financing requires that equity be sufficient to complete the common areas and that individual mortgages cannot be opened until the *building* is ready for occupancy. Sales may occur in different locations and uniformity of completion cannot be scheduled to take care of the various units sold and possibly ready for occupancy. Although lower floor apartments may be completed, until the elevators or services for the entire building are completed, an owner or mortgagee takes great risk in advancing funds on individual mortgages.

Before sufficient apartments are sold to assure the project as a condominium, the risk that it may remain a rental project is present. The construction loan therefore must be processed as on an investment property.

EQUITY YIELDS

The construction cost of a condominium is greater than an apartment property and the rents that could be assigned as an investment property do not support the higher cost. The amenities built into a condominium are similar to those of home ownership. The capitalized value of the units will not equal sales prices unless a low capitalization rate is used, similar to the capitalization rate on a residence. The difference therefore between cost and value must be absorbed in equity. The difference in valuation will cause an increase in equity of from 10% to 15% or the reduction in the mortgage from 80% of cost to 65% to 70%.

Profit to the sponsor does not accrue in parcels as in a land development wherein the recapture of cost and profits can progress as homes or developed lots are completed. Because the condominium units are horizontal and the common areas require completion in full before complete recapture, the equity must remain for longer periods.

A BROAD MARKET

In northern climes the condominium market is analogous to the single family home market for *permanent* occupancy. In southern areas and winter resorts condominiums appeal to the owner seeking occupancy at his pleasure throughout the year, and rental income in his absence. Rental often supports the monthly maintenance payments for the entire year, while the owner occupies the apartment during the "off" season and rents during the "in" season. In Hawaii, Texas, and Florida this operation is prevalent and sales are made with rental and carrying charge appeal. During periods of non-occupancy management provides periodic inspections and reports of condition to the owner. This feature is especially appealing to retirees who like a permanent home without the necessity of constant attention, permitting them to travel.

The developer with subdivision and apartment experience can successfully promote a condominium if he assumes proper financial responsibility. Further, it is essential that the proposed project be equipped with the necessary qualities which differentiate it from merely an apartment project for rental and the ownership of a "home in the sky."