TWIN CITY CONVERSIONS

THE CASE STUDIES: HOW THE FINANCES WORK

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by
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PUBLISHER'S NOTE

This work is part of a series of publications that developed from a study of housing conversions in the Twin Cities metropolitan area. The conversion studies were directed by Barbara Lukermann. Milo Pinkerton worked with her as project assistant. Graduate students in the Humphrey Institute of Public Affairs conducted most of the survey work in conjunction with a workshop in the Institute's Planning Program during the spring of 1980. Titles of the complete series of conversion publications are:

<u>Twin City Conversions of the Real Estate Kind</u>. Barbara Lukermann and others. CURA 81-5.

<u>Twin City Conversions. The Condominium Market: Surveys of Activity, Developers, and Buyers</u>. Barbara Lukermann and Milo Pinkerton. CURA 81-6.

<u>Twin City Conversions. The Displacement Factor: A Survey of Outmovers</u>. Thomas L. Anding and Rebecca Smith, CURA 81-7.

<u>Twin City Conversions. The Case Studies: How the Finances Work</u>. Milo Pinkerton. CURA 81-8.

<u>Twin City Conversions. The Complete Inventory: 1970-1980</u>. Milo Pinkerton. CURA 81-9.

INTRODUCTION

These case studies analyze three projects as illustrative examples of condominium conversions in different settings with developers who differ in background and in motivation. The case studies also seek to:

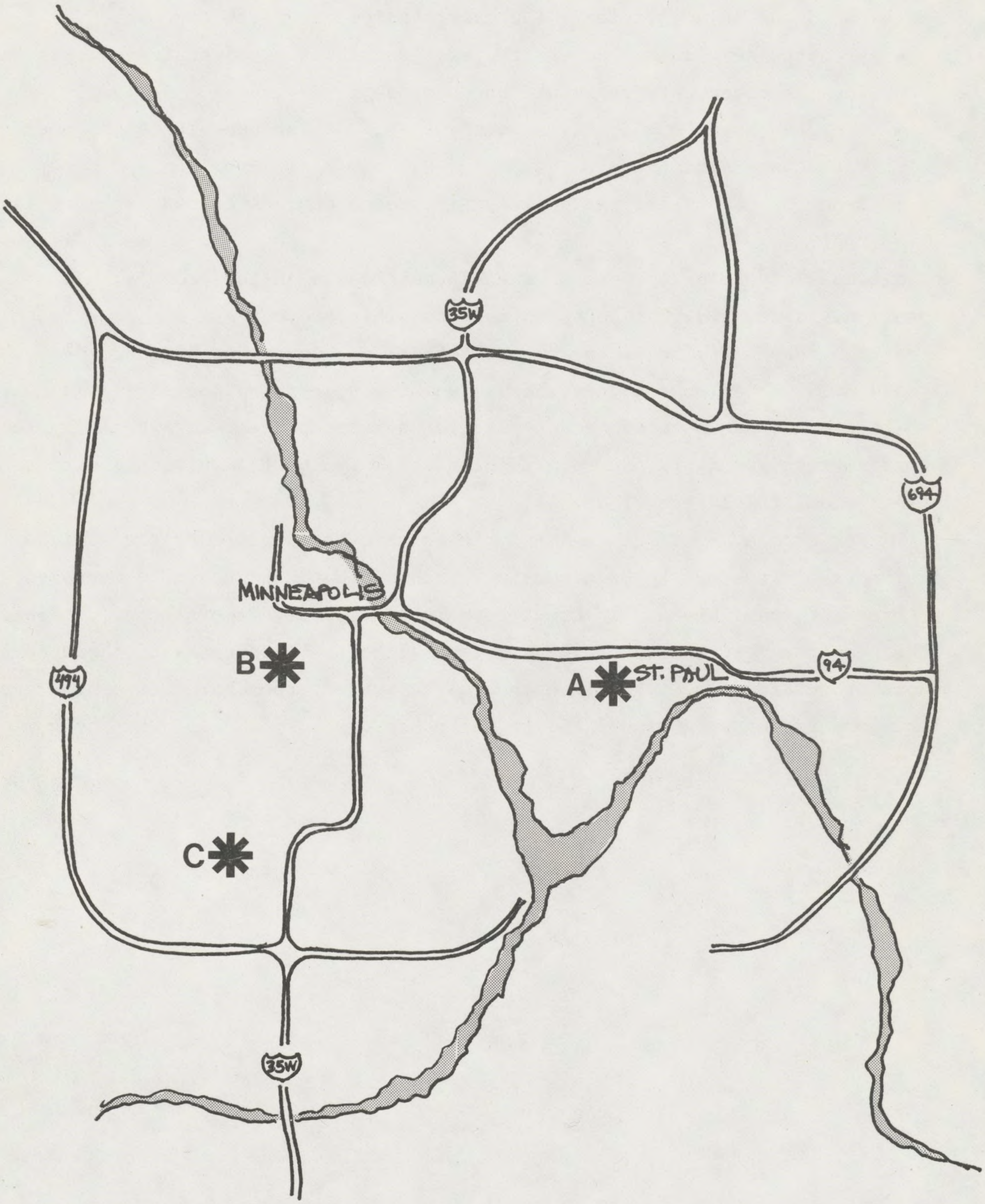
- from the developers' point of view, describe the conversion process and look at components of income and expense;
- from the buyer's and city's perspective, look at benefits each receives with conversions;
- describe how public tax policies influence choices to own rather than rent.

Additional attention focuses on winners and losers in the process, how much profit is made, and what constitutes a feasible project.

Two inner-city projects were selected: one in an established, desirable residential location and the other in an area undergoing gentrification. The third project was suburban and typical of a large project in a building less than fifteen years old, and providing several types of amenities and recreational facilities (see Figure 1).

Projects A, B, C are real and financial data supplied by the various developers are assumed to be accurate. Each project was chosen to represent a "class" of conversions. In order to maintain the developers' confidentiality, the property descriptions have been generalized. Photographs of three comparable properties were taken in each area to reflect the character of the property and to act as a visual aid to the reader.

Figure 1. LOCATION OF THE CASE STUDIES IN THE TWIN CITIES AREA



DESCRIPTION OF PROPERTIES

PROJECT A

An 1880s vacant side-by-side duplex was moved to a different lot in the Historic Hill area of St. Paul and converted to four one-bedroom condominium units. A zoning variance and numerous city permits were required.

No cost was incurred in the building purchase, yet renovation required totally gutting the interior and an extensive facelift of the exterior with care paid to architectural detailing. Off-street parking, laundry facilities, and security entrances comprised the amenity package.

A Building Comparable to Project A in the Historic Hill Area of St. Paul

This area has been undergoing condominium conversions since 1970 and is leading St. Paul in the number of conversions. Buildings converted are typically wood-frame or brick and built before 1900. They are converted to two to twelve units with financing help through below market end-loan mortgages.

Project A's developers are a non-profit organization, among the first to halt neighborhood deterioration by supplying housing for those wishing to remain in the city in rehabilitated homes. This project supplied 8 1/4 percent financing for first-time, single, moderate income home buyers.

PROJECT B

Built in the 1920s, this three-story brick apartment building was purchased by first-time landlords in 1976 and converted to condominiums. One efficiency was added to an even mix of one and two-bedroom apartments. Major improvements were made to electrical and plumbing systems while high grade carpeting, kitchens, and security systems are all new.

Immediately surrounding are three-story red brick apartment buildings with a few large single family homes in an area having few conversions and generally above average monthly rents.

Fifty percent of those renting purchased units in the same building with only one and a half month's rental income lost per unit. The targeted market consisted of young singles or marrieds, childless, with income between $14,000 and $22,500 annually to qualify for below-market financing (HOP IV program).

The developers were typical of inner city Minneapolis smaller project developers in that HOP IV below-market 8 percent end-loan financing was used, and this project was their first real estate conversion experience. The motivation of these developers to pursue long term careers in real estate development was not typical of this developer group as a whole. Great care was paid to having a high quality, successful project.

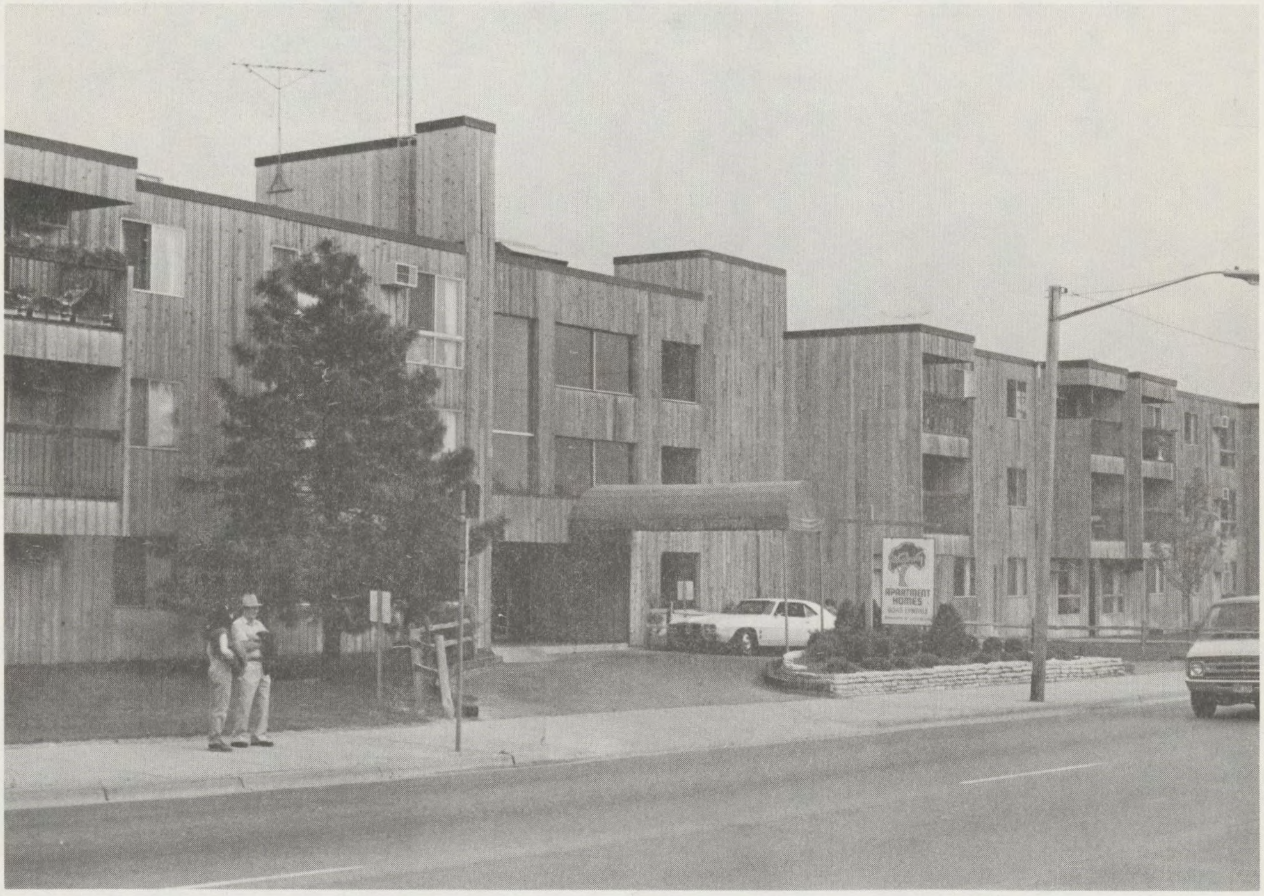
A Building Comparable to Project B, Adjacent to Downtown Minneapolis

PROJECT C

Built within the last ten years, this soundly constructed three-story large apartment complex with 90 percent one-bedroom units offers an extensive list of amenities aimed at young "swingles," with moderate to high incomes, who are "activity" oriented.

The developers had great expertise in suburban condominium development, gained through years of experience in the Twin Cities and elsewhere. Newer buildings, prestige neighborhoods, and large projects are always sought to capitalize on in-house appraisers, attorneys, and feasibility analysts.

Acquisition cost of a convertible apartment building in Project C's class is calculated on a rough rule of thumb: calculate total sellout price of each unit as condominium, subtract estimated expense to convert at 30 percent (may be as low as 25 percent), subtract developer's profit of 15 percent, which leaves 55 percent of sellout for acquisition. Assumptions are 10 to 20 percent down payment on three to five year purchase money mortgages, $5,000 minimum developer's profit per unit, developer's overhead at 5 percent, and an acquisition cost that is greater than the building's value as a rental building.



A Building Comparable to Project C in Suburban Minneapolis

Table 1. GENERAL DESCRIPTION OF CASE STUDY PROJECTS

Category	A	B	C
Location	St. Paul	Minneapolis	Edina
Number of Units	under 10	10 - 20	over 100
Change in Number of Units After Conversion	+2	+1	0
Occupancy Prior to Conversion	vacant	100%	98%*
Physical Description	two story wood frame	three story brick	three story wood with balconies
Date of Original Construction	1880s	1920s	1970s
Neighborhood	Historic Hill	adjacent to downtown	high density suburban residential
Character of Neighborhood	In area of large pre-1900 homes with considerable re-hab and condo conversion.	In area of three story apt. buildings and single family homes. Considered highly desirable place to live.	In area of apt./condominiums close to shopping centers, freeway. Desirable suburban location.

*Full occupancy with small number in transition.

THE CONVERSION PROCESS

Even though many of the same items must be completed in any condominium conversion there are distinct subtleties involved in every project as Figure 2 graphically portrays.

Conversion involves a common set of phases for each project. First, a rough estimate of expenses or feasibility report occurs. Second, necessary fees, permits, and gap/end-loan financing has to be secured. Third, rehabilitation takes place (except for Project B where sales to residents started first). And fourth, marketing and sales occur with completion of the process when the last unit is closed.

Project C took 24 months to complete with two-thirds of that time spent on sales; while Project B was shortest at 7 months with only 1 month for sales effort; and Project A required 14 months, one weekend spent on sales, and over 60 percent of the total time used to renovate.

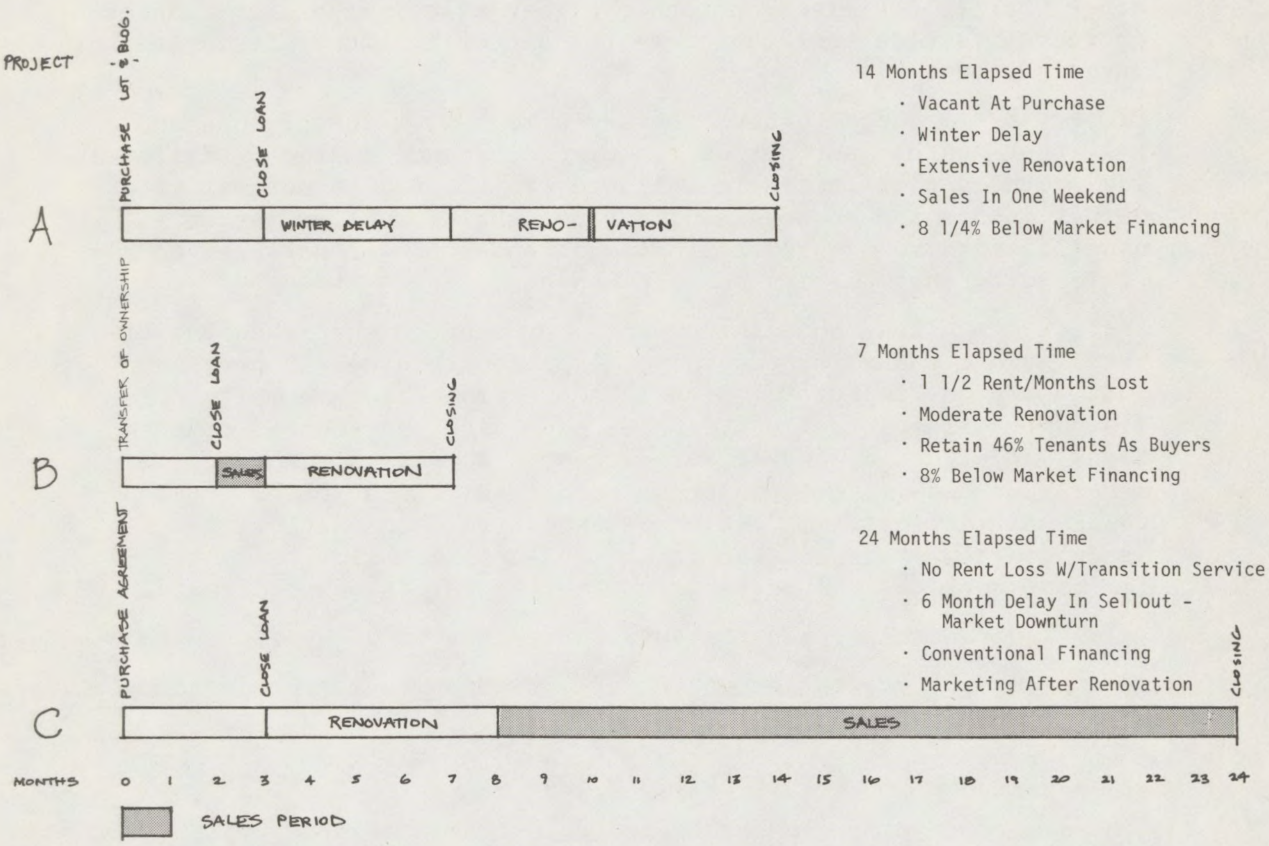
Sales occurred at different times in each development. Project B had sales occurring two months into the process to existing tenants before any renovation took place. Project C, as a marketing tool, required all common area renovation to occur before any sales effort commenced thus enhancing the visual change to ownership. Sales effort of Project A consisted of one advertisement in the St. Paul Dispatch and word of mouth. This resulted in a complete sellout in one weekend midway through renovation.

Each developer started the process with different considerations. The non-profit historic preservationist started when purchase agreements on the lot and building were signed. Developers of Project B were owner/converters and commenced with a paper transaction transferring ownership to a new entity so as to avoid double capital gains tax. The experienced developer of Project C had a purchase agreement written up and secured by a note which allowed ninety days in which to find gap-loan financing, end-loan commitments, and feasibility reports. This was all done with no cash "tied up" in the project.

Recurring themes were echoed: (1) hiring highly skilled professional construction personnel as higher out of pocket costs are recouped in fast completion time, (2) doing a complete renovation since bulk purchases reduce costs and are very marketable, (3) sales occurring faster than anticipated (Project A and B). This led the developers to believe that a higher unit price could have been achieved, yet long periods to sell require large amounts of capital to cover carrying costs. Better use of funds is to have lower than market prices, fast turnover, and then reinvest into the next project.

A closer look at each project's income and expense statements follows to help explain how and why the private market place must assess the risks and opportunities of conversion housing.

Figure 2. DEVELOPMENT TIME LINES BY PROJECT



COMPONENTS OF INCOME AND EXPENSE

The purpose in analyzing income and expense statements for three different projects is to compare sources of costs and income and the proportionate share of various components. Net profit or loss is a financial indicator of how successful a project is as an investment. In this case Project A incurred a small loss (-2.7 percent), while B and C returned around 16 percent on gross income (Table 2). Fifteen percent was considered a minimum by Project C's developer. Findings are as follows:

<u>Project A</u> - Moderate success can be given to Project A. Although a small loss was incurred, it was in line with the goals of that non-profit organization. A shorter development time-line to reduce finance charges totaling 7 percent, higher sales prices, or changes in reconstruction could have created a profit. Other items seem at bargain rates.

<u>Project B</u> - A quick turnover of seven months, with only one and a half rent months lost per unit, lowered finance charges. Extremely low overhead plus fast sales allowed Project B a 16 percent return on net income and a successful project rating. Below market financing aided in a quick sellout and kept professional fees to a minimum, further cutting down on expenses.

<u>Project C</u> - A low 5 percent overhead expense, higher than anticipated sales, and tight control on expenses returned 16 percent of net income on Project C, which is above projection in spite of a six month delay in sellout. Sales promotion, personnel, commissions, model units, and tenant discounts comprised a whopping 7 percent of total income which is more than renovation cost and professional service fees combined. Except for acquisition, the finance costs on construction loans, end-loan commitments, and closing costs paid by the seller comprise the largest expenditures.

Sales and financing are greater expenses for large newer suburban conversions as opposed to renovation costs for older inner-city projects. Land and building acquisition costs were coincidentally close for Projects B and C while they were minimal for Project A.

According to the developer of Project C: 30 percent should be spent on expenses to convert (the actual cost was 33.2 percent), 55 percent allocated for acquisition (the actual cost was 51 percent), thus leaving a 15 percent return (the actual return was 16 percent). Sales costs were greater than estimated. The minimum profit per unit of $5,000 was achieved and overall Project C was rated successful.

Table 2. INCOME AND EXPENSE STATEMENTS BY PROJECT

Item	Project A	Project B	Project C
Income			
Gross Sales Income	100%	98.2%	96.7%
Rental and Furniture Income	0	1.8	3.3
Total Income	100%	100%	100%
Average Income Per Unit	$43,000	$33,000	$47,000
Expenses			
Sales	under .01%	under .01%	7.4%
Professional Service and Fees	3.3	4.2	1.7
Financing	7.0	4.2	12.6
Operations	8.9	1.9	6.7
Renovation Cost	79.4	23.7	4.8
Costs to Convert	98.6%	34.0%	33.2%
Land and Buildings	4.1%[a]	50.1%	51.0%
Gross Profit/(Loss)	(2.7)%[b]	15.9%	15.8%

[a]Includes house moving and foundation costs.

[b]Includes staff costs which were expensed.

MOTIVATION TO BUY RATHER THAN RENT

According to our survey of buyers*, the motivations to own a condominium are chiefly: 1) as an investment in an inflationary economy, 2) for personal tax savings, 3) to provide constant monthly costs in an escalating rental market, 4) for security - in not having to move, and 5) for the intangible benefits of ownership.

To explain the economics of condominium ownership versus renting, a cost/benefit analysis of a one-bedroom unit in each of the three projects is presented in Table 3. Sales prices were as of June 1979 and varied between $50 and $60 per square foot. Financing allowed a 5 percent down payment on all projects, below market 8¼ and 8 percent interest rates for Projects A and B at a 30 year term, and an 11½ percent, 30 year term for Project C. Project A was originally vacant, Project B's monthly rent was $225 versus $347 after conversion, and Project C's rent was $295 versus a post-conversion cost of $527.

The hidden monthly costs/benefits are as follows: (1) add to the monthly condominium costs the opportunity cost of the down payment if it had been invested and was earning 10 percent; (2) subtract the principal build-up on the first year's condominium payments; (3) subtract the tax savings accrued through interest expenses and real estate taxes, calculated at 30 percent on a single income of $19,000. Totalling these adjustments to the monthly condominium payments reveals actual monthly costs of $261, $263, and $411 for each unit even before equity appreciation is considered.

Currently, a most attractive benefit in owning is equity appreciation. This is calculated as the difference between total condominium costs and rent before conversion, annualized, then added to the purchase price and divided by the purchase price. Projects B and C required only 1.2 and 3.4 percent appreciation for 1979 to break even with pre-conversion rents while condominium homes generally appreciated at around 15 percent between 1975 and 1980 in the Twin City area. Additional homeownership savings can be incurred as capital gains tax is shifted to a higher price residence upon sale until a one-time exclusion of tax on $100,000 profit is allowed after age 55. State of

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*Lukermann and Pinkerton, Twin City Conversions. The Condominium Market: Surveys of Activity, Developers, and Buyers. CURA 81-6. Minneapolis: Center for Urban and Regional Affairs, University of Minnesota, 1981.

Minnesota renter and homestead tax credit favors the renter yet is proportionately small.

Clearly, owning a condominium is a win situation as compared with renting. For as little as $2,000 down plus estimated closing costs of $650, households earning between $13,000 and $19,000 yearly, could have purchased into one of these projects and gained financially by shifting from their renter status.

Table 3. COMPARISON OF RENTAL COSTS AND OWNERSHIP COSTS FOR THREE ONE-BEDROOM UNITS

	Project A	Project B	Project C
I. Before conversion:			
Unit size[a]	800 sq ft	600 sq ft	760 sq ft
Monthly rent	0	$225[b]	$295
Rent/sq ft	0	$0.38	$0.39
II. After conversion:			
Unit sales prices 6/79	$41,000	$36,500	$41,500
Sales/sq ft	$ 51.25	$ 60.83	$ 54.60
Downpayment[c]	$ 2,050	$ 1,825	$ 2,075
III. Monthly condominium payments:			
Principal & interest[c]	$293	$254	$390
Association fee	$ 60	$ 53	$ 80
Real estate taxes	included	$ 40	$ 57
Total	$353	$347	$527
IV. Hidden monthly costs and benefits:			
Add: opportunity cost of downpayment (10%)	$ 17	$ 15	$ 17
Less: principal build-up	$ 26	$ 24	$ 13
Less: tax savings (30%)[d]	$ 83	$ 75	$120
V. Actual monthly cost (hidden costs and benefits in IV applied to payments in III)	$261	$263	$411
VI. Equity appreciation required to break even with rent[e]	--	1.2%	3.4%

a) Unit size remains unchanged.

b) Rent is low; $260 is estimated as the comparable market rent.

c) Project A - 8 1/4% interest, 30 years, 5% downpayment.
Project B - 8% interest, 30 years, 5% downpayment.
Project C - 11 1/2% interest, 30 years, 5% downpayment.

d) Median gross income, 1979, Twin City condo buyer was c. $19,000 = 30% tax bracket.

e) Twin City condominium appreciation has been 15% from 1975 to 1980.

CONVERSION EFFECTS ON REAL ESTATE TAXES

In Minnesota all properties are now to be valued at 100 percent of full market value, which is an assessor's estimate of what the property would sell for on the open market, usually less than a probable sales price. Assessed value is then computed at a percentage rate of full market value by property use as described in Table 4. The 1980 rates have not yet been approved by the State Board of Equalization but are shown under current proposed guidelines.

Table 4. REAL ESTATE TAX ASSESSMENT GUIDELINES BY PROPERTY USE

Use	1979	1980*
Commerical/Industrial	43%	43%
Apartment (4 or more units)	40%	38%
Residential (non-homestead)	32%	28%
Residential (homestead)	1st $21,000 at 18%; Balance at 20%	1st $25,000 at 16%; 2nd $25,000 at 22%; Balance at 28%

*Proposed 1980 rates. Residential rates have decreased since 1978 in order to offset large increases in property assessment values.

Multiplying full market value times the assessed valuation rate times the mill rate determines the gross tax. Mill rates vary each year by school district in each municipality and in 1979 were 0.0905, 0.1118, and 0.1151 for Projects A, B, and C, respectively. Residential properties homesteaded by January 2 are eligible for a 58 percent state tax credit (50 percent in 1979) up to a maximum $650 tax reduction.

After conversion, 1980 actual taxes due have decreased for two out of the three projects (Table 5) even though full market values have almost doubled. Instrumental in this reduction was a drop from the 32 percent 1979 non-homestead rate to the 1980 residential homestead rate, a slight change in mill rates, and a primarily 58 percent state tax credit to reduce gross tax by more than one-half. Minnesota state income taxes pay this credit to the county, which in turn pays the municipality and school boards, thus shifting the tax burden. Mr. Boris in the Minneapolis city assessor's office reported a similar situation to the Department of Housing and Urban Development in Washington* where value doubled, gross tax was greater than pre-conversion tax, yet net tax due was 40 percent less than the before conversion net tax.

Table 5. REAL ESTATE TAX ASSESSMENT BY PROJECT

Project	Municipality	Full Market Value			Actual Tax Due		
		1979 Before	1980 After[b]	Percent Homestead	1979 Before	1980 After[b]	+/-
A	St. Paul	$715[a]	$143,400	100%	$47[a]	$1,030	+
B	Minneapolis	$159,500	$510,050	100%	$6,387	$3,878	-
C	Edina	$2,500,000	$4,665,000	73%[c]	$83,708	$63,092	-

[a]$715 land value; building at zero dollar value; property owned by city at time of purchase.

[b]Estimated with projected valuations and homestead formulas; not yet approved by State Board of Equalization.

[c]21 units not yet registered; of those registered 84 percent homesteaded for 1980.

Project B has an assessed value in 1980 greater than the cumulative sales values, which might lend substance to the statement that the developer thought sales prices could have been raised. Homesteading was 100 percent in both Project A and B while registered homesteads were 73 percent as of August 25, 1980 for Project C. While only two units of Project C still remained unsold, 27 units had not yet been registered and therefore 1980 taxes may yet be lower than $63,092. The end result reveals that even though market value increased significantly, taxes notably decreased due chiefly to homestead credits and also to slightly lower assessment rates after conversion.

*Letter to Mr. Charles Connerly, Department of HUD, Washington, D.C., dated January 23, 1980.

IN CONCLUSION

Real estate is commonly a localized industry since each location, property, and community are different and the three condominium projects chosen reflect this diversity.

Success was achieved by all the case study projects with different barometers to measure this. Fifteen percent of net income was accepted as a minimum profit by two developers. Small increases in bridge or end loans or a downturn in sales could easily change the profit margin and make the business of conversions not worth the risk.

Conversions have resulted in new capital investment and an increased assessed valuation of the tax base for municipalities. The tax burden, however, is shifted to state income tax payers, thereby subsidizing homeowners. The benefit to the community by spillover effects of the increased real estate value is primarily in shifting the tax burden from property taxes to a wider income and sales tax base, that is, the key source of revenue for the state.

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