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The Whole $tory On Fractionals

Fractional resorts are in the midst of an explosive growth spurt... with no signs of a slowdown.

Unit sales have more than tripled since 1999, and more than 60 fractional projects are in various stages of development nationwide. In fact, fractionals may very well reshape the real-estate market for upscale second homes (as well as, to some extent, the vacation-lodging scene).

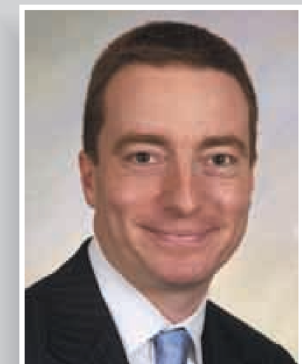
For those not fully aware of the parameters of the product, fractional resort products generally are luxury condominiums, townhomes or single-family homes, most of which are three-bedroom units ranging from 2,000 - 2,600 sf. Approximately two-thirds of fractionals are in ski resorts, with the others at golf or oceanfront properties.

Specifically, buyers purchase a deeded fractional interest that provides the right to use a unit on an annual basis for a variable amount of time, ranging from 1/7th - 1/12th of an entire year. Depending on resort location, unit size, amenities, services, guaranteed use time and other factors, fractional ownership interest prices generally range between $100,000 - $750,000 per share. Furthermore, the average interest sells for approximately $250,000.

And although fractionals may appear to be similar to timeshares, they differ greatly in terms of product type and service level, lower sales and marketing cost, the demographic profile of prospective purchasers and— perhaps most notably— financing options offered. Unlike timeshares, fractionals are marketed as a luxury product that also happens to be a smart real-estate investment.

The attractiveness of fractionals to entrepreneurial developers can be summed up in three words— affluent Baby Boomers. These consumers are less price-sensitive and better able to weather prolonged downturns in the economy. But, as these findings from a recent study show, they have other appealing characteristics as well:

MONEY talks



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- Not only are they entering their peak earning years, but they also will inherit additional wealth from their parents... the wealthiest generation in history.
- In 2002, an estimated 3.7 million households in the U.S. headed by adults 35 and older had annual incomes of more than $175,000. In the next five years, another 430,500 households (an 11% increase) will reach this income-qualifying threshold.
- Approximately three million income-qualified households do not own a vacation home or timeshare— a huge, untapped segment for fractional developers.

Now we get to money matters. Although the fractional resort market is currently very active, and growth prospects for the emerging industry are excellent, it can still be somewhat challenging for a developer to obtain acquisition or development financing for a new fractional product.

Traditional real-estate lenders, for example, may be reluctant to finance an unfamiliar asset class, while receivable-based timeshare lenders aren't interested in funding development costs. Clearly, what's needed is a hybrid model that incorporates both real estate and receivables financing.

The following case studies— one a ground-up construction project, and the other a second-mortgage loan— show typical financing hurdles, and issues, a fractional developer might encounter.

In case study #1, a developer constructing a luxury 19-unit fractional resort in Lake Tahoe, CA was stymied. Traditional real-estate lenders didn't want to get involved in a venture that looked like the timeshare business... but timeshare lenders didn't want to provide a $20-million loan for ground-up construction with little opportunity for end-receivable financing.

In this instance, we recognized an opportunity based upon the sponsor's quality, the location's desirability, and the fractional experience of the borrower's sales and marketing partner. This led to a 2.5-year, $26-million loan secured by a first mortgage on the property to cover 100% of direct construction costs, with a variable interest rate based upon a spread over the Prime rate. The loan closed within 60 days to meet a desired construction timeframe heavily influenced by weather.

In case study #2, a developer had partially completed the first phase of a proposed 22-unit luxury fractional project with ski in/ski-out access at a major Colorado resort destination. Because of poor soil conditions and other unexpected problems, the project was over budget by several million dollars, and construction was halted when the developing company's senior-mortgage lender would not provide additional loan proceeds to complete development.

To avoid the costly and protracted process of raising additional equity, the developer came to us for a one-year, $8-million second-mortgage loan to complete planned units. This loan had a variable interest rate for all-in pricing in the low to mid-teens (compared to the 25.00%-plus required by potential equity investors). The loan was closed within 30 days, and the initial 22 units were successfully sold out.

(It's worth noting the developer is now planning a second development phase at the same location.)

In the long run, the fractional market is building on its own momentum and gaining sophistication in all aspects of the business. As the concept becomes more widely accepted, competition will intensify, price points will fall, and new profit opportunities will arise. As such, those developers able to satisfy the discriminating tastes of high-end property buyers will no doubt reap plentiful rewards.

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