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Condo Market Bottoming With Morgan Stanley Reducing Loan Losses: Mortgages

By Hui-yong Yu - Feb 29, 2012

Morgan Stanley (MS) is finding the bottom in the U.S. condominium market.

The bank, which ended up as an owner of the largest luxury condominium project in the U.S. Northwest with other lenders after the developer defaulted on loans made at the height of the housing boom, cut prices by about 40 percent to jumpstart sales and reduce mortgage losses. About half of the 539 units at Bellevue Towers in Bellevue, Washington, have sold, with transactions more than tripling in the past year, said Patrick Clark, the broker for the buildings, completed in 2009.

"It's really been in the last eight to 12 months that we've started to see buildings sell out well," said Ben Kakimoto, a real-estate broker who specializes in condos at Keller Williams Realty in Seattle. "All the projects are benefiting now because there's been no new condo construction" in the area for the past four years.

Falling prices and a scarcity of new buildings are helping fuel home sales in the Seattle-Bellevue region, with condo transactions rising seven times faster than the average of 20 large metropolitan areas in the U.S. With evidence growing that housing is improving after helping trigger the last recession, lenders are chipping away at losses from projects created prior to the financial crisis.

Investor Confidence

Signs the economic recovery is accelerating, including a decline in the jobless rate to a three-year low of 8.3 percent in January, are also bolstering investor confidence in bonds tied to commercial properties from skyscrapers to luxury apartment buildings. The extra yield investors demand to hold top-ranked commercial-mortgage bonds rather than Treasuries has declined 56 basis points since December to 205 basis points, or 2.05 percentage points, according to a Barclays Plc index. That's the narrowest spread since June.

Work began on the Bellevue Towers in 2006, funded with $275 million of senior debt arranged by Morgan Stanley, including a $75 million construction loan from the New York-based bank, said Ira K. Glasser, the consultant who oversees the project on behalf of the lender group that owns it. An additional $165 million came from mezzanine loans and equity financing arranged by the developer, Portland, Oregon-based Gerding Edlen Development.

After credit markets seized up and home prices tumbled across the U.S., prospective buyers at Bellevue Towers canceled in droves. Of the 229 purchase agreements booked before closings began in 2009, only 43 were completed, according to the broker.

'Would Not Close'

"All the other early buyers either could not, or would not, close due to the financial crisis and the fact that real estate prices were dropping," Clark said.

Condo markets such as Bellevue, Miami and Las Vegas got overbuilt when debt financing was abundant.

About 4.7 percent of condo loans held by Fannie Mae were "seriously delinquent" in the third quarter, meaning more than 90 days overdue or in foreclosure, according to data compiled by Chandan Economics in New York. That compares with the 4.6 percent delinquency rate of all Fannie Mae home loans, and about 24 percent for subprime loans. The delinquency rate for condo loans peaked at 6.1 percent in the first quarter of 2010.

Lower appraisals and tightening mortgage-qualification standards have made it harder to buy homes. In January, 33 percent of Realtors said they had home-purchase contracts fail, up from 9 percent who said so a year earlier, according to the National Association of Realtors.

Lenders Take Control

Bellevue Towers's senior lenders took control of the development in December 2010 through a deed in lieu of foreclosure after Gerding Edlen went into default, said Glasser.

"It was a great project," said Mark Edlen, chief executive officer of the development company, which no longer has a stake in Bellevue Towers. "The market's the market." He declined to comment further.

Mary Claire Delaney, a spokeswoman for Morgan Stanley, declined to comment.

The new owners chose to cut prices and wait out a recovery instead of converting to rentals or unloading unsold units in bulk at large discounts, as some other projects have.

At the Bellevue Towers, where a landscaped courtyard connects buildings of 42 and 43 stories, a two-bedroom penthouse on the 41st floor was reduced to $2.6 million from $4.2 million, while a 13th-floor studio was cut to $289,000 from $481,500.

Revenue of $186.5 million from the 275 unit sales to date plus the estimated value of $220 million the broker places on the unsold units add up to about $407 million, less than the project cost.

'Small Profit'

"We are on target to make a small profit but nothing like what was originally envisioned," said Niko Paliouras, vice president of asset management at New York-based Hudson Realty Capital LLC, part of the lender group that owns Bellevue Towers. "The management team has done a great job of managing the sales process up to now and adapting to the market changes," said Paliouras, who toured the project six months ago.

"The way the economics are right now, it will be good fortune if at the end of 2014 we have managed to pay off the senior loan by selling all the units," Glasser said.

Compounding the potential revenue shortfall, carrying costs for Bellevue Towers such as interest on debt, property taxes, insurance and maintenance fees, have surpassed $10 million a year so far, said Glasser. As units are sold, the carry costs will decline, he said.

Tighter mortgage standards haven't been an obstacle at Bellevue Towers, as 42 percent of the condo purchasers paid cash, according to Clark.

Cash Sales

"We have marketed and sold properties since the 1990s and this is the highest percentage of cash sales we have ever experienced," said Clark. At prices 30 to 40 percent less than the original list, buyers may perceive real estate to be safer than other investments, he said.

Price cuts are helping shrink the inventory of new condos in the Seattle-Bellevue area, as in other U.S. markets. There were 725 unsold new condo units in the Seattle region as of Jan. 31, down from a peak of 4,815 units competing for sales in October 2007, according to Portland, Oregon-based Realty Trust City Inc., the broker for Bellevue Towers. At last year's average sales rate of 30 units per month, that equates to about 24 months of inventory, said Clark, the Realty Trust broker.

The national inventory of unsold existing condos and cooperative units fell 32 percent in 2011, to 291,000 units, from 429,000 units in 2010, according to the National Association of Realtors.

Condo Boom

The total number of condos in the U.S. jumped 44 percent from 2003 to 2009, according to the Census Bureau's American Housing Surveys for those years, which cover the market peak. There were 8.74 million condo units nationwide as of 2009, the most recent date available, up from 6.08 million units in 2003, according to the surveys.

In Bellevue, Washington, "we're overbuilt in condos right now," said Magen Michaud, a manager in the Development Services Department. The city issued no permits for new condo construction from 2009 through 2011, she said. In 2008, just two new condo projects were permitted, with a combined 517 units, about one-third of the record 1,506 units in 2007. Some rental apartments were included in the 2007 total.

Discounts also invigorated sales at other luxury condo developments in the region. Escala, in downtown Seattle, cut prices as much as 50 percent in March 2010 -- three months after coming to market and selling just five units, said Erik Mehr, the broker for the tower, which was financed by Deutsche Bank AG (DBK)'s RREEF unit. Since then, about 160 units have sold.

The Olive 8 high-rise in downtown Seattle also reduced prices in the past two years, according to its website.

'Losing Money'

While there aren't any official statistics for sales of new condos, sales of existing condos show that turnover in the Seattle-Bellevue area is outpacing many other large cities.

Sales of existing condos in the area rose 14 percent last year, to 6,916 units, or seven times the average 2 percent increase for 20 large metropolitan areas, including New York, Chicago, San Francisco, Miami, Phoenix and Las Vegas, according to DataQuick, a San Diego-based provider of property data.

Only the areas around Tampa and Miami in Florida and Portland, Oregon, had bigger sales increases within the group, according to DataQuick.

Escala expects 220 of its 269 condos to find buyers by the end of this year, and the rest probably will be sold in 2013, Mehr said. Often the most expensive are the last to sell.

"They're all losing money -- anybody who built at the peak and has all those carrying costs," said Mehr. "Maybe instead of losing $100 million, you're losing $30 million. That's a lot better."

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