TIMESHARE FINANCING: A LENDING OPPORTUNITY

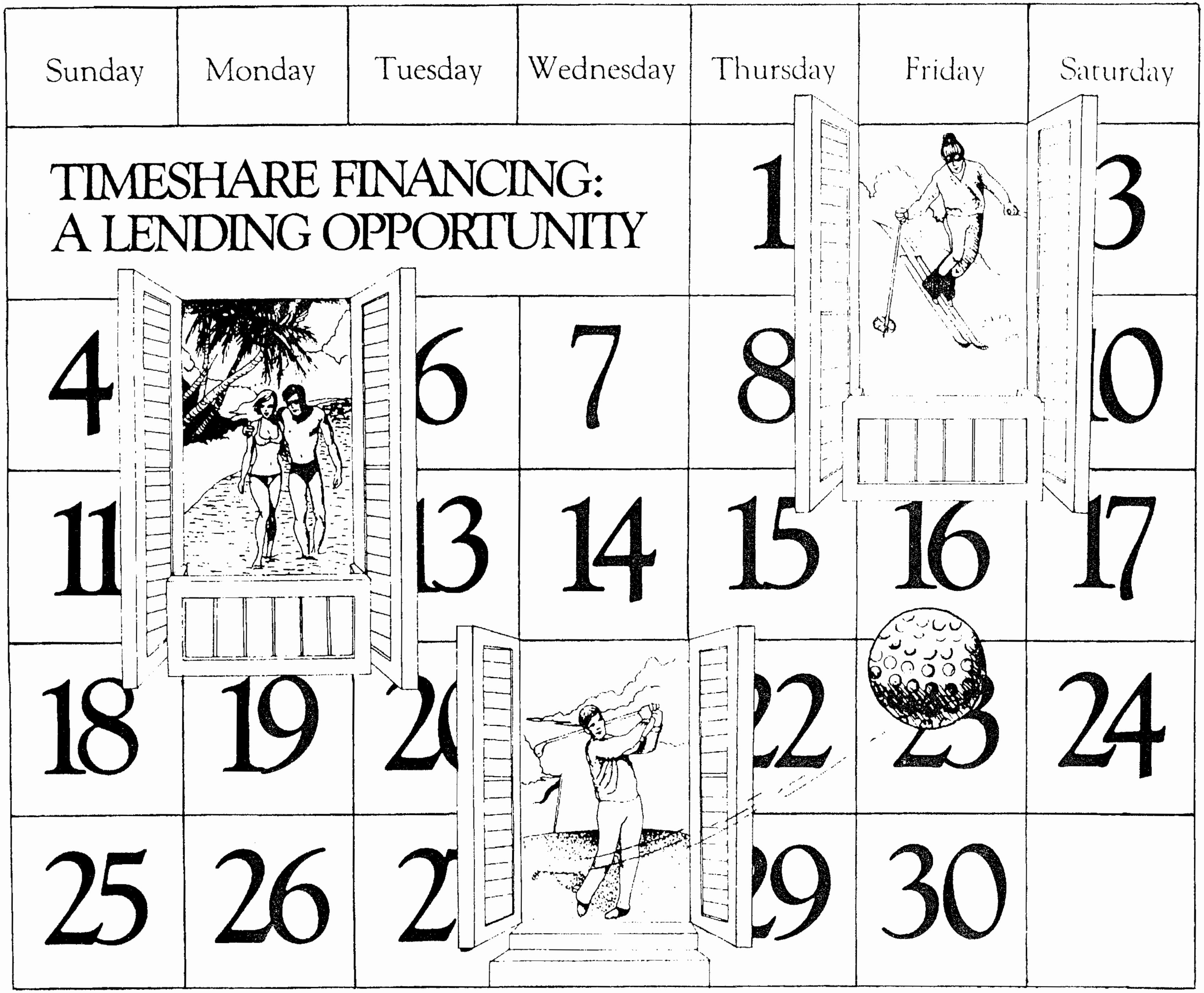
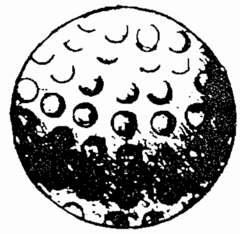


illustration by Christina Palmer



Greg C. Johnson

Timesharing is a generic term that describes many different types of real estate interval ownership. An effective way of explaining the concept of timesharing is the term "prepaid vacation" or, simply defined:

> Timesharing consists of selling a condominium unit for vacation purposes either to an owner or user for one or more weeks a year for a successive number of years, or in perpetuity.

Timesharing, of the right property, is a concept that gives the developer the advantages of reaching a wider market and achieving a wider margin of profit, while making the dream of second-home ownership a reality to millions of families not able, or not willing, to invest the large sums required for whole unit ownership.

In 1981, U.S. timeshare sales reached about $1.4 to 1.7 billion dollars. From 1975 to 1979, timesharing sales nearly doubled every year; spectacular growth in a remarkable new industry. Despite cyclical 20 percent plus peaks in the prime rate and limping general economy, U.S. timeshare sales in 1980 broke through the billion dollar per year level.

U.S. timeshare projects zoomed from about two dozen in 1975, when timeshare first appeared on any notable scale, to about 425 in 1980. A record number of new projects—over 100—began sales during 1981 even though financing throughout the real estate community was tight and movement was slow.

Reasons for growth

There are three basic reasons why the timeshare industry has experienced such growth. First, a great

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many people want to "have a place" in well known vacation areas. However, the cost of renting or buying a "whole" unit in such areas has become so high that it is out of the reach of most people and renting or purchasing doesn't make good economic sense, even for those who can afford it.

Second, timesharing offers a common sense way of securing high quality accommodations for periodic, seasonal use, but in a way that does not create a large financial burden for the buyer and relieves him of ongoing concerns about maintenance and management.

Third, there has been substantial appreciation in the value of timesharing units. This has added an investment aspect to the basic objective of personal use.

As over 30 million American families can afford to buy timesharing properties, the market penetration is still small and sales should continue to be high for the next several years. Any person who vacations for at least one week annually might be interested in purchasing a timeshare interval to enjoy the benefits of ownership and minimize the future costs of vacation expense.

Developer's financing needs

The cash flow in a timeshare project is a critical aspect of project planning and development. Front-end costs and non-recurring expenses in the early time periods of the timeshare sellout create potential cash flow shortages. The costs of acquisition, construction, or conversion are typically covered by the developer's equity contribution or an interim loan.

As cash flow from the sale of timeshare units develops, the developer repays his equity or debt financing. However, actual cash generated from the timeshare sales usually averages only 30 percent of total sales, (20 percent down payments and 10 percent total cash sales). The terms of a typical purchase contract might be: 20 percent downpayment, the balance paid monthly over 5-7 years at a fixed annual interest rate.

To provide for cash shortages and facilitate the repayment of interim financing, the developer might elect to:

1. Sell the timeshare purchase contracts to an institutional or private investor.
2. Hypothecate the loan contracts.

Under the terms of the first alternative, the developer is usually required to sell his timeshare receivables at a discount to create desired yields. In addition, the purchaser of the paper will usually require a 5 to 20 percent hold back on the face amount of the contracts as a cash reserve to provide for delinquency default. This method of receivable financing can be costly to the developer as well as create an immediate tax burden.

The second means of financing timeshare receivables is for a financial source to extend a line of credit secured by the timeshare contracts. While the formula used to determine the amount of credit or cash advance varies, the total cash advance will usually range from 60 to 90 percent of the face amount of the contracts. This method of collateralization enables the developer to retain more dollars from timeshare sales and defer his tax liability.

Lending opportunities

To date, timesharing project financing, both interim and permanent, has been limited in scope and variety. However, since 1978, credit companies and commercial banks have started to provide project financing. Recent surveys disclose that the financing of timeshare receivables has produced high yields with low delinquency and default rates.

While similar to consumer or installment credit, a properly structured investment in timeshare paper can offer much greater security at higher yields. As a portfolio consideration, timeshare paper offers a viable alter-

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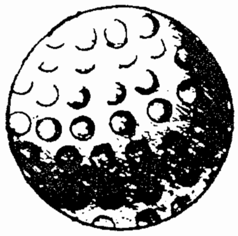

native to the fixed-rate, long maturity characteristics of residential mortgages. Even the new alternative instruments, RRMs, ARMs, VRMs, etc., provide only partial upward rate protection but a full downward rate risk.

Financial industry trends indicate a continued environment of constantly changing money costs associated with an increasing reliance on short-term liabilities. The challenge today is to match high cost, volatile liabilities with appropriate assets.

To understand how timeshare paper can solve the investment problem of matching assets with liabilities, an understanding of the timeshare paper characteristics and inherent risks is important.

Advantages

Hedgeable, high yield. The stated interest rate to the buyer on a timeshare purchase contract is typically higher than a normal mortgage. While the purchase contract may contain a fixed rate, the receivable financing to the developer can be done at a variable rate. Prepayment, prior to an already short maturity, increases the total acrual yield.

Short Maturity. The term of a buyer's purchase contract ranges from five to seven years, fully amortized with monthly payments of principal and interest. Frequently contracts are prepaid. Further, through hypothecation, the maturity of financing to the developer can be structured to range over three to four years.

First Lien. Financing to the developer is secured by an assignment of the developer's first lien position. In the event of default, first lien rights and remedies can be exercised.

Small Payment. The monthly contract payments made by the buyer to the developer are low because of the low initial contract balance. The chance of default is reduced. The payment record for this type of loan during the five years has been excellent. Because furniture and the other aspects of ownership are included in the purchase agreement, there is no additional cash requirement to the buyer.

Buyer Credit. Timesharing is a destination vacation product. As a result, the people who buy it are typically the same as those who visit quality destination resorts, many of whom would be able to purchase normal whole units. Thus, there is good financial strength behind the loan, which is a much smaller amount than that for a whole unit purchase. Too, the greater number of buyers provides a wider spread of risk over a given amount of money invested in a project.

Unlike a piece of undeveloped property (like a building), a timeshare week is an "active" asset used each year for the owner's vacation. Consequently, there is an ongoing and immediate interest in meeting financial obligations in order to be able to use the unit each year.

Developer Recourse. In the case of a hypothecation arrangement, in addition to the credit of the timeshare buyer, the developer becomes an added guarantor. Because the developer remains liable for the project, he has the responsibility for credit screening and delinquency collections. Should a contract become 60 days delinquent, the contract is then either replaced or repurchased by the developer.

Minimal Management Costs. Because the developer guarantees the paper, the costs of underwriting, credit review, and documentation requirements are minimized. Collections and delinquency reports furnished by the loan servicer are received weekly or monthly.

Risks

Default. Timeshare properties are second home investments and do have less consumer priority than a primary residence. However, most lenders reports and surveys show minimal delinquency and default (about 1 percent) to date. The price of timesharing weeks continues to increase, maintaining a margin of safety for the lender and providing incentive to the borrower to remain current on the purchase contract.

Security Liquidation. Foreclosure on a timeshare week can be costly and inefficient. Proper underwriting of the project, developer, and ongoing management help to refine the risk of foreclosure and liquidation.

Developer Insolvency. This, the greatest risk, could have a negative impact on project sales and increase the likelihood of contract defaults. Careful selection of quality projects in desireable locations sponsored by financially strong developers with good resort management capabilities will reduce this risk. However, should insolvency become a reality, there is a margin of safety to the lender.

The default cushion created originally still reduces and may eliminate any potential loss because more than 10 percent of the buyers would not likely default. Further, the condominium association controls the management of the resort and charges an annual assessment fee to cover the operating expenses. Therefore, even if the developer/owner abandoned the project, the resort could run efficiently by hiring a manager. Finally, personal liability on the part of the developer for the paper is further incentive to stay with the project.

Summary

In summary, when properly structured, timeshare paper offers an excellent investment opportunity. Having the same credit and collateral characteristics as a first trust deed, the timeshare investment generates an above average short-term yield—highly appropriate for the current market environment and portfolio requirements.

To be successful in timeshare lending requires first, a quality project, second, a knowledgeable developer, and third, a means of originating, underwriting, and servicing the timeshare financing opportunity. □