# When Will the Miami Condominium Market Recover?

## *Follow the Land, Man*

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***Note:*** *The following is commentary. The opinions expressed belong solely to the authors.*

SINCE 2003, DEVELOPERS HAVE BEGUN CONSTRUCTION ON 22,000 condos in downtown Miami, which is more than double the number built over the last four decades. "For sale" condominium inventory has doubled. Residential vacancies have doubled in the past year. Prices have slipped downward dramatically.

As lenders have tightened restrictions on mortgages for condos, the closing rate on downtown condo sales has dropped from 18 per day in 3Q 2008 to five per day in 4Q 2008. Everglades on the Bay, for instance, an 848-unit condominium facing Bayfront Park and Biscayne Bay started closings in November. By December 31st, it had closed 18 units. Another project of more than 700 units in the Brickell market closed 106 units and stalled. In that project, one of the penthouse units currently is being rented for $2,000 a month, or just $1 per foot per month.[1]

### BACKGROUND

In 2008, nearly 2.7 million square feet of condominiums, townhouses and single-family homes in coastal South Florida sold at an average discount of 43 percent. According to the Vultures Database™ (*CondoVultures.com*) that tracks residences where the price has dropped by at least 10 percent or $100,000, a total of 1,717 properties east of Interstate-95 in Miami-Dade, Broward and Palm Beach counties traded last year for a combined price of $775 million, down from a historical high of $1.33 billion. The overall price drop equates to a combined discount of more than $550 million off the historical high asking price for the properties. In each of the 12 months in 2008, an average of 143 residential properties in the Vultures Database sold at 57 cents on the dollar. For comparison, in 2007, there were 1,272 properties in the Vultures Database that sold at an average discount of 29 percent.

On Dec. 31, 2008, the Vultures Database was comprised of 4,301 condo units, townhouses and single-family houses in South Florida that had dropped in price by an average of 39 percent. Condos and townhouses, which account for 69.6 percent of the total, are down an average of 38.5 percent. Single-family houses, which represent the remaining 30.4 percent of the inventory, are down an average of 40.0 percent. According to the Vultures Database, the average price drop for condos in Greater Downtown Miami has been 41.8 percent, while across the causeway in Miami Beach, the average discount has been 34.3 percent.


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## DOWNTOWN MIAMI

This article focuses on one submarket, downtown Miami, to show specific actions on the part of planners, city officials, developers, lenders and speculators that have led to overextension and overbuilding to the detriment of the market and the general public. In Miami, for instance, rental vacancy more than doubled from 2.6–5.8 percent from November 2007 to November 2008. For perspective, vacancy rate was 3 percent county wide in 2001 for buildings 18 months or older.[2]

We have seen the enemy. And the enemy is us.

The table and graph below indicate land prices from 2000 through the end of 2008.[3]

*Figure A*

Land Prices

| PRICE | APPROVED | DATE | $/SF | $/UNIT |
|---|---|---|---|---|
| $9,000,000 | 560 | 12/1/2008 | $150 | $16,071 |
| $45,000,000 | 2,424 | 10/1/2008 | $183 | $18,564 |
| $18,100,000 | 560 | 2/1/2005 | $302 | $32,321 |
| $18,700,000 | 554 | 3/1/2005 | $401 | $33,755 |
| $19,475,000 | 560 | 6/1/2005 | $359 | $34,777 |
| $31,750,000 | 924 | 4/1/2005 | $358 | $34,361 |
| $190,000,000 | 3,000 | 3/1/2005 | $470 | $63,333 |
| $94,000,000 | 1,705 | 12/1/2004 | $443 | $55,132 |
| $38,948,537 | 1,276 | 8/1/2004 | $283 | $30,524 |
| $15,000,000 | 633 | 4/1/2004 | $200 | $23,697 |
| $14,600,000 | 516 | 1/1/2004 | $201 | $28,295 |
| $30,228,000 | 1,424 | 11/1/2003 | $56 | $21,228 |
| $14,700,000 | 516 | 11/1/2003 | $196 | $28,488 |
| $6,000,000 | 200 | 6/1/2003 | $192 | $30,000 |
| $25,000,000 | 866 | 5/1/2003 | $204 | $28,868 |
| $6,300,000 | 142 | 12/1/2002 | $223 | $44,366 |
| $8,750,000 | 343 | 12/1/2002 | $104 | $25,510 |
| $19,000,000 | 667 | 4/1/2001 | $170 | $28,486 |
| $12,500,000 | 360 | 4/1/2000 | $87 | $34,722 |

*Source:*
*Blazejack & Company, Land Sales Research File, (2000–2008)*

The land prices drop for high-density sites as the market becomes aware of the CMBS problems and financing availability diminishes. The new highest and best use for vacant sites today would include hotel, office and rental apartments, as well as retail. The big change will be a much smaller building envelope and lower FAR, all of which reduces the land value in a land residual model. This puts downward pressure on price points and elongates the recovery time frame. The two most recent sales are reflective of the 2002 prices prior to the run-up in values.

## ON THE WATER, CIVIC OVERSIGHT IS FOGGY

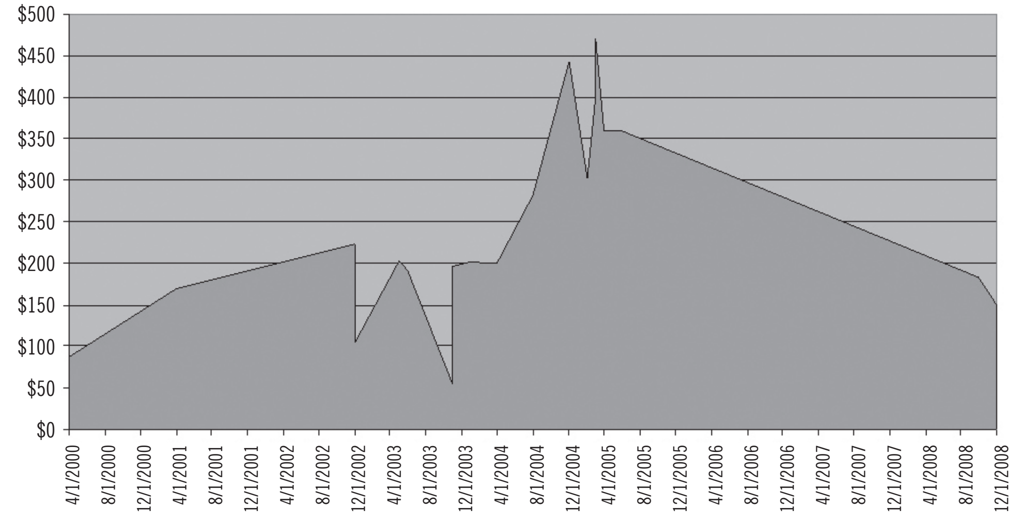
In every urban area that has access to a large body of water, whether it be a lake, river, ocean or back bay, there almost always comes an initiative for commercial real estate development on what are likely the most pristine of waterfront locations. Often these locations are those that the general public should enjoy and that government should actively protect for future generations. But when markets overheat, the development community seems to be unable to resist the opportunity to get at these locations. In the case of South Florida and, particularly Miami, there has always been a struggle between preservationists and developers. In the case of Miami-Dade County, the ebb and flow of the public-private struggle for saving or developing pristine waterfront parcels is emblematic of each real estate cycle, whether it be a frenzied run of overbuilding or the aftermath of a complete market collapse.

One longstanding example is the development of the Bayside Marketplace in the center of the City of Miami's downtown waterfront known as Bayside Park. The struggle for this 230,000-square-foot development with its accompanying 1,200 space parking garage went on for years. By the time the development commenced, the real estate cycle which prompted the fervor to create Bayside Marketplace had long passed, and most could not even remember how the idea had even been conceived. At one point, the developer negotiated the land lease (which had the City participating in net income) without defining the expenses, resulting in the elimination of any financial return to the City.

Another example is the Brickell Point Apartments which rested for many years in a decaying state on a river- and bay-front site of 99,000 square feet. A developer acquired the existing apartments, tore them down and commenced a luxury high rise development. In the process of excavating for the foundation, however, Indian artifacts were discovered, causing a delay. The developer then persuaded the City and State of Florida to pay a whopping $26,900,000, or $280 per square foot of land, to turn the site into a park that is now known as the Miami Circle site.[4] Later, the City allowed another developer to increase density for an adjacent project. The result was a very dense 1,700-unit

*Figure B*

Miami Condominium Land Sales 2000–2008




*Source: Blazejack & Company, Land Sales Research File, (2000–2008)*

project called ICON, constructed on 216,646 square feet of land, equating to 342 units per acre. The purchase price was $94 million, or $434 per square foot of land. The water and sewer infrastructure capacity for this massive development was greater than any previously built in the urban core. Despite the additional density granted by the city, no school or park contributions were made.

What is the possible nexus between the discussion of public-private land use on waterfront sites, and the recent cycle of overbuilding in the Miami-Dade County condominium market? A case in point is a 2.496 acre waterfront site in the prestigious Brickell Avenue submarket of downtown Miami, known as the Villa Magna site. This site received a Master Use Special Permit from the City of Miami in 2004 for a development that would contain 780 condominium units in a 45-story tower, equating to 313 units per acre. Subsequently, as the marketplace began to change and fears of overbuilding in the luxury condominium market grew, the plan for the site was altered to include hotel and condo-hotel use combined with office space. As of 1Q 2009, the same site is being leased to the City of Miami by the developer for $1.00 per year for use as a park since, due to the saturated condominium and office space markets, there is no other viable use for the site.

Now rented for just $1 per year, the Villa Magna site sold in 2001 for $15.5 million, or $142 per square foot of land. In 2004, the site was offered for sale for $87.0 million, or $806 per square foot, equating to $111,000 per unit—roughly double the per unit price of the ICON site. Today, the real estate tax assessed value is $38,054,100, or $350 per square foot, and the real estate taxes are $852,782.[5] Thus, in handing the site to the City for public purposes, the developer saves that amount each year, and the City looses that amount in tax revenue. The death walk has begun, and the unintended consequence of this change in land use is the first barrier to recovery of the marketplace.

How could this change in land use and "greening of the neighborhood" be a barrier to the recovery of the luxury condominium market? Tax assessments throughout the City in new condominium and existing projects are trending downward. Consequently, the City will be forced to contract for services in a market that needs such services as an amenity to facilitate recovery. It is reminiscent of an earlier decade when the City of Miami did not pay attention to the collapse of the office market. Values and tax collections retreated, and the City's bonds were put on watch, so much so that the State of Florida installed oversight on City financial activities.

The current inventory of new condominium units in this sub-market exceeds 22,000.[6] In the current marketplace in Miami-Dade County, using fundamental demand, and without making adjustments for the bulk sale of unsold condominium units, it is reasonable to assume that a 10-year supply of condominium units exists. Sales at prices less than the hard cost of construction would likely mean that the value of the land, the developers' initiative, design fees, soft costs, legal fees, marketing costs and interest expenses are burned to the ground and lost forever. This would be a scorched earth outcome.

### RESET PRICING: ANOTHER STEP DOWN THE DEATH WALK

What does reset pricing mean for existing condominium housing stock where mortgages are at prices that are higher than bulk sale prices of new inventory? The reset pricing of formerly mature and stable projects is creating a disconnect throughout the urban condominium asset class in Miami. One project finished in 2003, known as Jade, was sold out prior to Certificate of Occupancy; 70 percent of its units were sold by October 2002.[7] There were 300 reservations within two weeks of releasing the first 30 units in August 2002.[8] Jade now has a significant number of its 340 units in foreclosure. There are now three mature buildings in the Brickell submarket with disproportionate numbers of foreclosures pending.[9] In 2008, The Vue at Brickell had 49 foreclosure actions pending, and The Club at Brickell had 54.[10] Combined, these three buildings in the same submarket (Jade, the Vu, and the Club) exceeded $100 million in mortgage foreclosures[11], which puts unforeseen financial pressure on the condominium associations, and would cause a good faith purchaser to take pause at any price because of the uncertainties with respect to the viability of the condominium association and its ability to maintain the asset. It is important to note that when lenders foreclose on condo units, they are not required to pay the monthly fees that accrue during the foreclosure process; those costs are borne by the association. Lenders often delay foreclosure sales to avoid paying association fees. Financial pressure on condominium associations is a second barrier to recovery of the luxury condominium market in Miami.

### THE TRIPLE BYPASS

The securitization of mortgage loans has fostered a complete abdication of prudent underwriting and has resulted in a new phenomenon which we will call "the triple bypass."

In the triple bypass, three important underwriting protocols were ignored. First, businesses were created with telephone boiler rooms to conduct "inspections"—actual site visits for property inspection did not occur. Second, due diligence modeling, such as a rental income analysis, was bypassed as part of construction loan underwriting. Third, the real structure in condominium purchase agreements, including meaningful deposits being placed at the time of execution of the contract, the time of commencement of the project and at a time certain during the construction phase, were ignored. Such contract provisions would have ensured a high degree of certainty that contracts would close.

In the triple bypass, everything that comes from the heart of a sturdy real estate model was abandoned for artificial and insider trading on land and development schemes, coupled with the ultimate artificial element, "the Buyers Club." Buyers Clubs were predominately groups of speculators who executed preconstruction purchase contracts that were fully assignable and were subsequently flipped to other speculators after the developer closed on construction loans.[12] Essentially, this was a fraud perpetrated on the lender, but the model allowed lenders to abandon prudence and discipline without prying into the number of contracts that each speculator held. In previous eras, purchasers were not allowed to have a half-dozen contracts in the same building. In the recent cycle, the only prudent actors in the game were the mezzanine lenders, who studied the credit scores of unit buyers and scanned buyer lists for active flippers.[13]

### COMES NOW THE INTERNET

No one ever imagined that there would be trading of purchase and sale agreements for luxury condominiums across continents by virtue of the Internet and powerful Web sites. But, marketing Web sites of developers and real estate brokers have created an artificial perception of the depth, strength and durability of the condominium market.

This perception was enhanced through actual sales initiatives by developers in overseas markets. The result was implied demand that is irrational when compared to actual, fundamental demand.

### IMPACTS FROM SEIZURE IN CREDIT MARKETS

Conventional lending for luxury condominium purchasers has become more stringent, with higher equity requirements and substantiation of income. The requirement for a higher equity contribution on the purchase of individual condominiums puts further downward pressure on price points and elongates the recovery timeframe.

### NEW GUIDELINES FOR FANNIE MAE LOANS: A NEW BARRIER TO RECOVERY

Fannie Mae has issued new guidelines that Florida condos and condo conversions, and, in some cases, older condos, must meet before it will fund loans:

- At least 70 percent of the units in new condos must be presold.
- No more than 10 percent of units can be owned by a single entity.
- No more than 15 percent of units in *all* condos can be more than 30 days past due on association fees.

- No more than 20 percent of a condo can be devoted to commercial use.
- All condos, new and old, must have fidelity insurance, which protects association funds from fraud.
- The seller is not allowed to help with down payments or offer other perks, like deductions of association fees, unless they are disclosed.
- Condos must have hazard insurance.
- When investors buy in established projects, at least 51 percent of units must be owner-occupied.[14]

These are the sort of restrictions a successful project would require. People who are buying today should want these restrictions and, in some cases, even more restrictions. For instance, there is a growing consensus that renters do not "work" in luxury buildings for a variety of reasons, such as unit size, approval processes from associations and maintenance issues with non-resident owners, to name a few.

## CONCLUSION

The economic recovery will be a painful recovery in every sector. Ultimately, Miami will have a phenomenal housing stock in its urban area, and will be extremely attractive for working professionals. The early part of getting there, though, will feel like a death walk. As we follow the land and condominium prices downward we can see where the point of illogical correction might occur. That is the point of logical correction amplified by fear. In this case, that will result in the elongation of the process to recovery.

The barriers or impediments to recovery are institutional in nature and include Fannie Mae rules; bank underwriting standards; lack of appropriate infrastructure for family occupancy of condo inventory, such as quality schools; destabilized condominium associations; the price disconnect between current sales price points and existing mortgage values; declining real estate tax assessments; and pressure on city services at a time when those services are a requisite to recovery.

Additionally, in 2010, the downtown Miami submarket will receive a four-year supply of Class "A" New Office space. Existing buildings will be cannibalized through aggressive leasing of new projects. The flight to quality that most always occurs in such an environment will most likely occur in 2010, leaving an array of quality buildings unable to make debt service payments. This will introduce another arena of financial instability to the submarket, and will lead appraisers and lenders to exercise further caution. This downward pressure on the urban office market is evidenced by the cancellation in February 2009 of a ten-year, $58 million lease on 115,000 square feet of office space at Brickell Financial Center, a project to be completed in 2010.[15] Because of the recent collapse of Stanford Financial, another 90,000 square feet of office space came back to the market.[16] Combined with the Bilzin Sumberg cancellation, the total is 205,000 square feet of office market space on the market.[17]

Mere bulk acquisition of unsold inventory will not resolve these issues. The bulk purchaser intends to resell at a price point that is attractive, and is at least $100 per foot more than the acquisition. Consider a bulk purchase at $200 per square foot and three-year subsidy of the asset of at least $15 per foot per year. That totals $45 per square foot over a three-year period, and $60 per foot over a four-year period without return of capital or risk-adjusted return.

There is no doubt that those who purchase from the supply of new condominiums at deep discounts will ultimately make serious profits. Our suggestion is that the big jackpot will be in the acquisition of drastically discounted urban land, because that is what will be in short supply. ■

## ENDNOTES

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