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Valuing Sponsor Shares in a Cooperative Apartment

As the number of cooperative apartments increased in the early and mid-1980s, some cooperative corporations sold part or all of their stock to a co-op sponsor. With the advent of the recession and the increased public perception of potential pitfalls in cooperative ownership, many sponsors have fallen on hard times. The valuation of an independent co-op sponsor's shares not owned by the cooperative's tenant corporation is addressed here.

Cooperative (co-op) ownership is defined in *The Appraisal of Real Estate*, tenth edition, as:

> A form of ownership in which each owner of stock in a cooperative apartment building or housing corporation receives a proprietary lease on a specific apartment and is obligated to pay a rental which represents the proportionate share of operating expenses and debt service on the underlying mortgage, which is paid by the corporation.[1]

The corporation that holds the shares, referred to as the tenant corporation, also holds title to the real estate. A tenant corporation keeps a project functioning on a daily basis, managing landscaping, exterior building maintenance, and processing of receivables and expenditures, among other things. This is similar to the management of an apartment complex, with only a few expense differences.

A sponsor markets the co-op form of ownership, which can be wholly or partially owned by a tenant corporation or can be an independent entity. This is a leasehold position in which a sponsor is subordinate to a tenant corporation by virtue of its stock ownership, and is leasing the right of possession and use either to a shareholder on a proprietary lease basis or to a renter on a standard lease.

The purchasers, called stockholders or shareholders, also have leasehold interests. They own stock in the corporation equal to the number of shares necessary to purchase their units. By owning these shares of stock, shareholders can vote on issues that affect the co-op's development, such as the election of a board of directors.

The proprietary lease of a shareholder specifically creates a lessor–lessee affilia-

1. Appraisal Institute, *The Appraisal of Real Estate*, 10th ed. (Chicago: Appraisal Institute, 1992), 132.

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tion, details the rights of both parties, and establishes the obligation of the shareholder to pay a proportionate share of operating expenses and debt service, collectively known as the maintenance fee. Essentially, the lease gives occupancy and the stock gives ownership, although the real estate itself is not owned by a shareholder.

CO-OP INDUSTRY PROBLEMS

There are a great many problems faced by the co-op industry. Some of these problems are outlined as follows in Bruce Pollack's article, "Underwriting and Valuing Co-op Debt and Equity":

> The 1986 tax legislation stripped tax shelter benefits from investors who had purchased co-op shares for occupied units. Anticipated windfalls never materialized because tenants in residence continued to occupy their units. Co-op converters (self denominated as sponsors) encountered low rates of acceptance by so-called inside subscribers. When as many as 85% of the units of a converted property went unsold, sponsors were forced to provide out-of-pocket capital in order to cover cash flow shortfalls that arose as monthly maintenance charges exceeded rent collections from the tenants in residence. . . . Many sponsors borrowed against packages of unsold shares, causing their streams of red ink to intensify. Many sponsors who have been unable to turn over their tenancies and dispose of their units have either filed for bankruptcy or have severe financial problems. . . . Co-op unit prices have plunged . . . potential purchasers, who are waiting for a bottom to appear before buying, have accelerated the price decline.[2]

Even if a sponsor's cash flow and market problems are resolved, however, co-ops have inherent competitive disadvantages compared with other forms of real estate. Some major marketing liabilities include, most notably, a lack of third-party financing and the price attractiveness of condominiums.

DISADVANTAGES OF CO-OPS

While every form of real estate has its inherent pros and cons, of specific interest to the valuation of unsold co-op projects are the following disadvantages, which have significantly affected their viability.

- A co-op corporation, through its bylaws and regulations, has a significant amount of control over the transfer of ownership. A potential unit buyer must be approved by the board of directors for a sale to occur. The screening process is therefore more restrictive than on the open market because all shareholders have a monetary interest in the financial capability of a buyer. This is a form of liquidity loss and is even more acute if a buyer is a typical trade-up buyer who will have more financial capability in the future and desire another form of real estate.
- The success of the entire co-op entity is directly related to the success of the co-op corporation. Further, the financial burden of a shareholder also directly depends on the success of the co-op corporation. As Pollack notes:

> It has become all too evident that the co-op form makes it possible for the sponsor's financial problems to create parallel problems for the cooperative corporation and its tenant shareholders. Should a sponsor who controls a large number (possibly a majority) of shares cease making maintenance payments, the corporation may have insufficient funds to pay not only the building's operating expenses (e.g., heat, insurance, real estate taxes and repairs) but the underlying mortgage. To meet operating cash flow shortfalls, the co-op corporation may deplete its reserve fund or working capital, specially assess the shareholders for the difference, or quickly vote on, pass and implement an increase in the operating budget that raises each remaining unit owner's monthly charges.[3]

- A shareholder's investment, most of which is usually the down payment, may be completely lost if the cooperative corporation goes bankrupt. According to Pollack:

> Should the corporation be unable to pay the monthly underlying mortgage charges, the mortgagee may foreclose on the co-op corporation's sole asset, the real estate, and effectively take title to all units. Thus, the foreclosing lender *can wipe out the tenant shareholder's equity, cancel the stock and leases, and extinguish claims of all other lenders against the*

2. Bruce Pollack, "Underwriting and Valuing Co-op Debt and Equity," *The Real Estate Review* (Spring 1992): 55.
3. Ibid., 54–55.

stock and lease. The unit owner or borrower, however, continues to be obligated to repay his or her personal debt, which now becomes unsecured.[4] (Emphasis added.)

- Third-party real estate financing has almost completely vanished for co-ops in many major markets. With no financing, few buyers can afford to pay all cash.
- Real estate prices have dropped significantly for all other types of substitute real estate. While single-family housing has become more affordable, of particular interest is the drop in condominium sale prices. Buyers who can afford the large co-op down payment can easily afford a condominium—thus almost all of the demand for co-ops has shifted to this substitute real estate product that has no ownership or maintenance fee risk.
- If the economy picks up, major developers are poised to develop entry-level single-family, condominium, and townhouse projects that will offer stiff competition for existing co-op projects, especially the older converted co-ops.

APPRAISAL METHODS

As a response to the disadvantages of cooperatives and the decline in many real estate markets, co-op sponsors with a material number of unsold units have continued to rent them. This is the highest and best use for most co-op sponsors. The only accurate way to measure the income and sale components, the partial division of expenses between the tenant corporation and the co-op sponsor, and the decline in rentable units resulting from unit sales is through a discounted cash flow (DCF) analysis.

Flow of funds between the tenant corporation and the sponsor

To understand the method for valuing a co-op sponsor, it is necessary to understand the flow of funds through the entire cooperative project. Figure 1 graphically presents this flow.

The vast majority of operational expenses is incurred by the tenant corporation. It has sole responsibility for certain expenses, such as sanitation, snow removal, and landscaping, that are passed on to a sponsor in the form of monthly maintenance charges. Other expenses, such as payroll, management, and repairs and maintenance are incurred by the tenant corporation, but they are also incurred by the sponsor. Of these expenses, some entail a division of responsibility between a tenant corporation and a sponsor while others are simply incurred twice. For example, a general repairs and maintenance expense for the building exterior and roof may be incurred by a tenant corporation and passed on, while a sponsor, as landlord for its units, incurs the expense of interior unit repairs such as broken appliances or bathroom repair. An example of an expense that is incurred twice with no division of responsibility is the management expense, with both a tenant corporation and a sponsor having separate, overlapping management staffs for their respective functions.

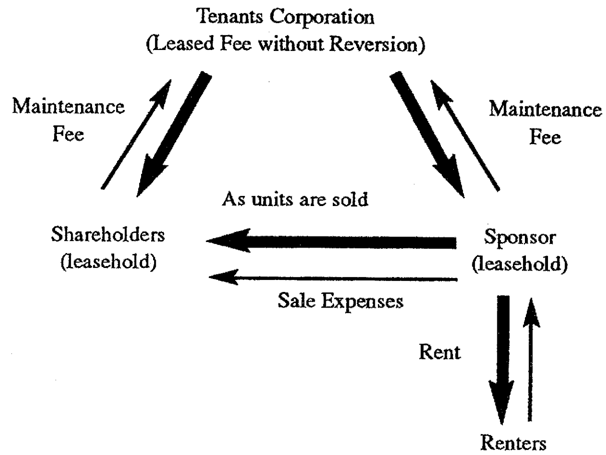
Basically, a tenant corporation incurs almost all project expenses and passes them on to a sponsor as part of its monthly maintenance fee. A sponsor then incurs certain expenses as part of its rental operation. The sponsor also incurs sale expenses when co-ops are sold, such as brokerage, advertising, renovation, and closing (when a unit is sold, a sponsor no longer incurs the rental expense associated with that unit, so its total rental expense responsibility decreases as units are absorbed). A sponsor receives rental income from the unit owners and must then pay its own expenses and its share of the maintenance fee bill (comprised of the tenant corporation's operating expenses for the project as a whole and their underlying debt service).

Six steps must be followed to derive a sponsor's value:

1. Derive the economic or market sale price for co-op units.
2. Determine an absorption rate for the co-ops.
3. Determine the amount of operating expenses and debt service (i.e., maintenance fee) attributable to a sponsor's interest (i.e., shares).

4. Ibid., 55.

FIGURE 1 Co-op Flow of Funds



4. Estimate a sponsor's rental expenses for all rented units.
5. Estimate a sponsor's co-op sale expenses when units are sold.
6. Capitalize the net operating income (*NOI*) for the co-op component by an appropriate discount rate and capitalize the *NOI* of the rental component by an appropriate discount rate. The two components have different risks and require different discount rates. A lower rate reflects the rental component, which is usually the highest and best use of the shares. A higher rate is applicable to the co-op sale component for the converse of this.

To help clarify the DCF analysis that follows, a practical example based on an independent cooperative sponsor appraisal is presented.

DERIVING ECONOMIC SALE PRICE

A sponsor's sale history can be the foundation for developing economic sale price. Unfortunately, the downturn in the market over the past several years as well as the drop in absorption levels indicate that an economic sale price lower than past price levels is appropriate. Listing prices from individual owners in the project, if lower than a sponsor's asking price, can provide some insight into economic sale price. If there are listings of units that were repossessed by a financial institution, these listing prices can also provide an indication of the market sale price. Because co-ops are not publicly recorded, it can be extraordinarily difficult to obtain comparable co-op sales and it is not uncommon that insufficient comparable data exist to support this estimate. In many markets, financing is gone for co-ops, so the asking price is effectively all cash and an appraiser must adjust the economic sale price to reflect this.

Regardless of which method is used to derive economic sale price, it is important for an appraiser to compare a sponsor's co-ops with condominiums using a form of sales comparison analysis. Comparison with both newer condominium projects and older converted condominium resales should be performed; the adjusted sale price indicators should support each other. An adjustment for real property rights conveyed must be made because the sale of a co-op is personal property and a condominium is real estate; the disadvantages of the cooperative form of ownership can also be handled in this adjustment. Adjustments for such factors as location, physical condition, and project amenities should also be made if necessary. Finally, because a co-op buyer would purchase a unit subject to the existing financing, the underlying debt service on a per-unit basis should be subtracted from the adjusted sale price to arrive at the economic sale price for the co-op units.

DERIVING THE ABSORPTION RATE

Obviously, the historic absorption rate of the project should be investigated. As co-op sales are extraordinarily difficult to obtain, it may not be possible to track an accurate absorption history from unsold comparable co-ops. An appraiser must consider these factors and the reaction of the market to the disadvantages of co-ops in deriving the absorption forecast.

DERIVING THE SPONSOR'S PROPORTIONATE SHARE OF OPERATING EXPENSES AND DEBT SERVICE

To determine the maintenance fee (i.e., operating expenses and debt service) that is billed to a sponsor by a tenant corporation, an appraiser should begin by obtaining the income and expense statement for one or more years from the tenant corporation. Most of the expenses of the tenant corporation are directly comparable with other apartment income and expense statements or the Institute of Real Estate Management's (IREM) *Income/Expense Analysis for Condominiums, Cooperatives and PUDs Survey*.[5] An appraiser should first determine the items that can be accurately compared with these sources, which may include laundry and pool income, professional fees, office expense, gas and electric, water and sewer, sanitation removal, extermination, landscaping, and advertising. The higher assessment of co-ops prohibits comparison with comparable apartment buildings. An allocation of reserves for replacement should also be made; this is the sole responsibility of the tenant corporation.

Other expenses are borne by a tenant corporation and a sponsor in proportion to their respective functions and cannot be accurately compared with either other apartment expense statements or the IREM expense study. For instance, a tenant corporation is responsible for the entire project's exterior building maintenance, sponsors are responsible for interior building maintenance only for their units, and individual co-op owners are responsible for their units. Payroll expense reflects only the tenant corporation's exterior building maintenance staff because unit owners and renters are responsible for their units and unit owners and renters subcontract repairs to other professionals. The tenant corporation's management fees reflect only that portion of the project that it controls, namely the exterior of the entire project. Insurance is lower for the tenant corporation because no internal liability is assumed for the sponsor's units. Finally, supplies are lower for the tenant corporation because only the exterior of a project needs to be repaired. An appraiser must be aware of these distinctions to properly apply these expenses to the sponsor.

Once the operating expenses for the tenant corporation have been derived, the debt service that is part of the maintenance fee billed to a sponsor must be considered. An appraiser should derive the debt service from a discussion with a tenant corporation, the mortgagor. The tenant corporation's most recent operating statement will have a line item for this expense. If audited financial statements are available, the notes to the financial statement will usually disclose the terms and principal repayment schedule that can be used to derive the debt service.

After considering the operating expenses and debt service attributable to a tenant corporation, an appraiser must then prorate this total maintenance fee according to the number of units a sponsor owns. Because an appraiser cannot accurately predict which units will sell first during the holding period, calculating pro rata by units rather than by shares is preferable. There may be different allocations of shares for the various units in the project, such as first floor versus second floor, one-bedroom versus two-bedroom, and scenic view. As units are sold, the maintenance fee attributable to a sponsor's units decreases.

In many markets, financing is gone for co-ops, so the asking price is effectively all cash and an appraiser must adjust the economic sale price to reflect this.

ESTIMATING THE SPONSOR'S RENTAL EXPENSES

Sponsors are responsible for management, professional fees, insurance, an advertising allocation (if necessary), and interior repairs and maintenance for their units. When compared with a tenant corporation, the rental management expense is a duplication of effort. Professional fees such as accounting and legal expense (most notably eviction costs), interior repairs and maintenance, and interior in-

5. Institute of Real Estate Management, *Income/Expense Analysis for Condominiums, Cooperatives, and PUDs Survey* (Chicago: Institute of Real Estate Management).

TABLE 1 (continued)

CO-OP RENTAL OPERATING EXPENSES										
Tenants Corporation										
Incurred Expenses										
Sponsor's share of operating expenses (3)	$1,290,838	$ 1,285,611	$1,278,908	$1,270,646	$ 1,248,731	$1,224,336	$ 1,184,657	$ 1,141,475	$1,094,635	$1,043,957
Sponsor's share of debt service (4)	$ 1,473,718	$1,425,000	$1,376,282	$1,327,564	$1,266,667	$1,205,769	$1,132,692	$1,059,615	$ 986,538	$ 913,462
Total maintenance fee liability	$2,764,556	$ 2,710,611	$2,655,190	$2,598,210	$2,515,397	$2,430,125	$2,317,350	$2,201,090	$ 2,081,173	$ 1,957,419
Sponsor's Rental Incurred Expenses										
Management (5)	$ 86,754	$ 86,122	$ 85,375	$ 84,505	$ 82,632	$ 80,571	$ 77,386	$ 73,936	$ 70,211	$ 66,195
Professional fees	$ 15,000	$ 14,461	$ 14,386	$ 14,293	$ 14,046	$ 13,772	$ 13,326	$ 12,840	$ 12,313	$ 11,743
Insurance	$ 25,000	$ 24,102	$ 23,976	$ 23,821	$ 23,411	$ 22,954	$ 22,209	$ 21,400	$ 20,522	$ 19,572
Interior repairs & maintenance	$ 60,000	$ 57,845	$ 57,543	$ 57,171	$ 56,185	$ 55,089	$ 53,302	$ 51,360	$ 49,252	$ 46,972
Total sponsor rental incurred expenses	$ 186,754	$ 182,530	$ 181,280	$ 179,790	$ 176,275	$ 172,386	$ 166,223	$ 159,536	$ 152,297	$ 144,481
Total co-op rental expenses	$ 2,951,310	$ 2,893,141	$2,836,470	$ 2,778,001	$ 2,691,672	$ 2,602,511	$2,483,573	$2,360,626	$ 2,233,471	$ 2,101,900
Co-op net rental operating income	$ 139,218	$ 182,299	$ 220,328	$ 255,992	$ 286,386	$ 313,615	$ 333,266	$ 348,382	$ 358,664	$ 363,903
Present value factor at 12%	0.8889	0.7901	0.7023	0.6243	0.5549	0.4933	0.4385	0.3897	0.3464	0.3079
Co-op present value of net rental income	$ 123,751	$ 144,036	$ 154,736	$ 159,816	$ 158,916	$ 154,706	$ 146,137	$ 135,764	$ 124,241	$ 112,046
Co-op present value of net rental income	$ 123,751	$ 144,034	$ 154,736	$ 159,816	$ 158,916	$ 154,706	$ 146,137	$ 135,764	$ 124,214	$ 112,046
Co-op present value of net sales income	$ 163,354	$ 137,285	$ 115,357	$ 101,726	$ 111,666	$ 98,355	$ 103,601	$ 91,131	$ 80,094	$ 70,333
Co-op net cash flow (6)	$ 287,105	$ 281,319	$ 270,093	$ 261,602	$ 270,582	$ 253,061	$ 249,738	$ 226,895	$ 204,335	$ 182,379
Sponsor present value of cash flow	$ 2,487,109									
Sponsor reversionary value (7)	$3,207,039									
Total sponsor value	$5,694,148									

*There is no allocation for debt service because shareholders pay maintenance fees directly to the tenant corporation and the sponsor is no longer responsible for maintenance fees on those units.

surance correspond only to a sponsor's units and are divisions rather than duplication of responsibility.

Most sponsors have several units assigned to a sale center and model units. A small inventory of units ready to meet immediate demand is also often set aside and should be subtracted from the total number of rentable units.

DERIVING THE SPONSOR'S CO-OP UNIT SALE EXPENSES

A sponsor's co-op unit sale expenses include a brokerage commission, advertising, closing, renovation, and entrepreneurial profit. Sponsors have their own sale force and the brokerage commission should reflect the reduced brokerage cost of this in-house staff. An appraiser should also obtain an inventory of units that are and are not renovated to properly apply a renovation expense to the units of the sponsor. Entrepreneurial profit should reflect the current market; in markets where real estate values and demand have dropped, 10% is appropriate.

CAPITALIZING THE *NOI*s

After individually deriving the *NOI* of the sale and rental components, these should be capitalized by their appropriate discount rates. A much higher discount rate is applicable to the sale portion to reflect high risk, low returns, and the slow absorption of most markets. A relatively low, riskless rate is necessary for the units rented as apartments, which reflects the highest and best use and greater returns from apartment renting in most markets as well as the public's negative perceptions of co-op ownership.

DERIVING THE REVERSION

The reversion is calculated based on the rental income in the final year of the projection. All rental expenses are deducted from the gross rental; a sponsor's proportionate share of debt service is not subtracted from income. The ratio of total units to rentable units must then be multiplied by the net rental income because a sponsor typically holds several or more units for both rental and sale model units. Once these calculations are made, the net rentable income is derived. This is capitalized by an appropriate terminal capitalization rate, and sale expenses should be subtracted from this amount to derive the net reversionary price. An appraiser should make a slightly lower allocation for sale expenses because co-op sales are not real estate transfers and do not pay transfer tax. Finally, the net reversionary sale price should be multiplied by the final year's discount rate to arrive at the present value of the reversion. A numerical example of this calculation is found in Table 1.

CONCLUSION

The valuation of a cooperative apartment sponsor is not a difficult task as long as an appraiser understands the division of expenses that occur within a project. Using two discount rates allows an appraiser to accurately reflect the inherent risks and returns of the unit sale and rental components. This type of valuation will become more common as co-op sponsors struggle through the recession.

APPENDIX

Comments on Table 1

General

1. Total project size is 702 units; the sponsor owns 375 units.
2. Rental incomes and expenses increase by 3% annually. Sale income increases 3% annually starting in 1996 to reflect soft market conditions.
3. One-bedroom rent is \$700/month and two-bedroom rent is \$800/month.
4. No reversion in leasehold position.
5. Total rental expenses decrease as units are sold. Upon sale the sponsor is done with these buyers and they make their payments directly to the tenant corporation.

Cash Flow Footnotes

1. Sponsor doesn't receive parking, laundry, or vending income; this is the responsibility of the tenant corporation.
2. This property is in a strong rental market with historically high occupancy. Vacancy rate of 1% as a result of natural lease turnover and 1% to collection loss has been assigned.
3. Total tenant corporation market expenses derived by comparison with other apartments × (units remaining to be sold/total units in project).
4. Fixed tenant corporation debt service of \$2,850,000 × (units remaining to be sold/total units in project).
5. Management for sponsor is 3% of effective gross rental income.
6. Sponsor's net cash flow is the amount of money remaining to pay any sponsor leverage such as loans for converting units.
7. Reversionary value is calculated from rental income. The equation was presented earlier in the analysis. Numerically, it is calculated below:

   (Tenth-year gross income − tenth-year sponsor's proportionate share of operating expenses − tenth-year total co-op rental expenses) × (225 remaining unsold units/218 units from which rental income is calculated) ÷ a terminal capitalization rate of 12%. From this amount, 5% selling expenses are subtracted. Finally, this net reversionary sale price is multiplied by the tenth-year discount rate to arrive at the present value of the reversion. Numerically, this becomes:

   $$((((\$2{,}465{,}803 - \$1{,}043{,}957 - \$144{,}481) \times (225/218))/.12) \times .95) \times .3079 = \$3{,}207{,}039$$